OVERSIGHT HEARINGS ON ROYALTY-IN-KIND FOR FEDERAL OIL AND GAS PRODUCTION

OVERSIGHT HEARINGS

BEFORE THE

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

OF THE

COMMITTEE ON RESOURCES
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

JULY 31 AND SEPTEMBER 18, 1997, WASHINGTON, DC

Serial No. 105–41

Printed for the use of the Committee on Resources

U.S. GOVERNMENT PRINTING OFFICE
45–026 CC WASHINGTON : 1997

CONTENTS

	Page
Hearings:	
July 31, 1997	1
September 18, 1997	55
Statements of Members:	
Cubin, Hon. Barbara, a Representative in Congress from the State of Wyoming	1
Prepared statement of, September 18, 1997	55
Maloney, Hon. Carolyn, a Representative in Congress from the State of New York	5
Prepared statement of	8
Romero-Barceló, Hon. Carlos, a Delegate in Congress from the Territory of Puerto Rico,	3
Prepared statement of, July 31, 1997	4
Romero-Barceló, Hon. Carlos A., a Delegate in Congress from the Territory of Puerto Rico, July 31, 1997	57
Prepared statement of, September 18, 1997	59
Thornberry, Hon. William M. "Mac," a Representative in Congress from the State of Texas, July 31, 1997	55
Statements of witnesses:	
Brian, Danielle, Executive Director, Project on Government Oversight	62
Prepared statement of	201
Brown, Robert E., Associate Director, Minerals Management Service, U.S. Department of the Interior	86
Prepared statement of	264
Cohelan, Timothy, Esquire, Cohelan & Koury	69
Prepared statement of	249
Darouse, David, Mineral Revenue Regional Auditor Supervisor, Department of Natural Resources, Baton Rouge, Louisiana	23
Prepared statement of	119
Hagemeyer, Fred, Coordinating Manager, Royalty Affairs, Marathon Oil Company	33
Prepared statement of	141
Hamm, Sue Ann, Vice President, Oil Marketing/Sales, Continental Resources, Incorporated	35
Prepared statement of	154
Henderson, William, Market Development Representative, Gulf Canada Resources	60
Prepared statement of	191
Magagna, Jim, Director, Office of State Lands and Investments, Office of Federal Land Policy, State of Wyoming	25
Prepared statement of	121
Neufeld, Bob, Vice President, Environment & Government Relations, Wyoming Refining Company	71
Prepared statement of	257
Nichols, Larry, President, Devon Energy	31
Prepared statement of	130
Quarterman, Cynthia, Director, Minerals Management Service	45
Prepared statement of	181
Reid, Spencer, Deputy Land Commissioner, Texas General Land Office	19
Prepared statement of	21
Rorschach, Richard, National Chairman, National Association of Royalty Owners	63
Prepared statement of	208
Rothschild, Edwin S., Public Affairs Director, Citizen Action	65

	Page
Statements of witnesses—Continued	
Rothschild, Edwin S., Public Affairs Director, Citizen Action—Continued	
Prepared statement of	213
Segner, Edmund, III, Executive Vice President and Chief of Staff, Enron Corporation	37
Prepared statement of	172
Smith, Linden, Managing Director, Barents Group	67
Prepared statement of	224
Additional material supplied:	
Briefing paper	96
Congressional Research Service, Library of Congress, Memorandum from Marc Humphries and Lawrence Kumins	270
Crude Oil Royalty Payment Analysis, Report to the State Land Offices of Colorado, New Mexico, and Texas	138
DiBona, Charles, American Petroleum Institute	94
Petroleum Marketing Act	162
Questions from Mrs. Cubin and Mr. Romero-Barceló and answers from witnesses	291
State of Louisiana, prepared statement of, submitted by David Darouse	119

OVERSIGHT HEARING ON ROYALTY-IN-KIND FOR FEDERAL OIL AND GAS PRODUCTION

THURSDAY, JULY 31, 1997

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES, COMMITTEE ON RESOURCES,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:05 p.m., in room 1334, Longworth House Office Building, Hon. Barbara Cubin [chairman of the Subcommittee] presiding.

STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Mrs. CUBIN. The Subcommittee on Energy and Mineral Resources will come to order. The Subcommittee is meeting today to hear testimony on royalty-in-kind for Federal oil and gas production. Under Rule 4[g] of the Committee Rules, any oral opening statements at hearings are limited to the Chairman and the Ranking Minority Member.

This will allow us to hear from our witnesses sooner and help members keep to their busy schedules. Therefore, if other members have statements, they can be included in the hearing record under unanimous consent.

The Subcommittee meets today to review issues concerning the collection of production royalties due to the United States from Federal oil and gas leases on shore and on the outer continental shelf. During the last Congress, Chairman Calvert held a hearing to review the initial evaluation by the Minerals Management Service of the pilot program the agency had conducted in the Gulf of Mexico for natural gas royalty-in-kind.

That effort led to inclusion of language in the Appropriations Committee report for the 1997 Interior Department's spending bill urging consideration of further royalty-in-kind initiatives by MMS.

Many of us in Congress view the idea of a broad based royalty-in-kind program as a way to greatly diminish the enormous costs associated with audit and enforcement functions of collecting royalty-in-value.

For fiscal year 1998, the House has funded the valuation and compliance subactivities within the MMS budget at $68.3 million, but the true costs are still much higher because the Federal Government must expend substantial legal and administrative resources to answer protests, appeals, and litigation which ensue from differing interpretation of the value of oil and gas for royalty purposes.

Lest anyone forget, let me remind you that I represent the State of Wyoming in this body. And my state bears by far the largest portion of any state's cost burden under the so-called net receipts sharing formula which was codified as permanent law in the Omnibus Budget Reconciliation Act of 1993.

And by my quick arithmetic, the State of Wyoming has had over $50 million taken from its half of the Federal mineral lease receipts since the inception of the net receipts sharing methodology in fiscal year 1991.

The cumulative burden upon the states with onshore Federal leases for fiscal year 1997 alone is $22.1 million representing one-fourth of the cost of administering onshore mineral leases by the BLM, the U.S. Forest Service, and the MMS.

Without question, savings in these administrative costs, which may be realized through efficiency gains such as collecting oil and gas royalties-in-kind rather than in-dispute value, will reduce the burden upon the states paying the Federal Government's freight, as well as enrich the U.S. Treasury to the benefit of taxpayers throughout the nation.

To my way of thinking, there simply must be a better way to more efficiently collect what is owed to the United States in return for the right to explore, develop, and produce oil and gas from Federal lands; more efficient for the Feds and, therefore, by way of the net value sharing formula, less burdensome on the states and, yes, more efficient for industry which must put their money and capital at risk in the first place so there would no income to the Federal Government or the states.

Now, I realize that royalty-in-kind theoretically looks good, but putting it into practice is not necessarily cut and dry. But should we shy away from pursuing the idea because a particular segment of the industry or perhaps a particular state or two has certain problems with this method, I say absolutely not, nor should we in Congress simply take at face value allegation by folks with a vested interest in the status quo that R-I-K is a money loser.

But we must keep in mind the end goal. Increased efficiency means greater net revenues to all parties involved. I take seriously my job as Chairman of this Subcommittee, and I intend to see that that remains our focus. My purpose then in calling today's hearing is to attempt to set in motion a consensus-seeking effort not unlike that of two years ago, which ultimately resulted in the passage of a bill which President Clinton was eager to sign, the Royalty Fairness Act.

I understand that there are naysayers within Congress, some of whom may believe I have tried to stack the deck in this oversight hearing. I disagree strongly with that assertion, but this will not be the final hearing on royalty-in-kind. And we will hear from other witnesses in September who may perhaps have fundamental differences over whether or not R-I-K is an idea worthy of pursuit.

Furthermore, I have agreed to our Minority's request to have Representative Carolyn Maloney of New York as our first witness today, given the fact that she seems to have an abiding interest in royalty collection. And certainly I share that with you. I welcome you here today, Mrs. Maloney, and now I recognize the Ranking Member, Mr. Carlos Romero-Barceló for his opening statement.

[Briefing paper may be found at end of hearing.]

STATEMENT OF HON. CARLOS ROMERO-BARCELÓ, A DELEGATE IN CONGRESS FROM THE TERRITORY OF PUERTO RICO

Mr. ROMERO-BARCELÓ Thank you very much, Madam Chair, and we appreciate the opportunity to review the possibilities for a royalty-in-kind program in the Federal oil and gas leasing program.

And it is particularly agreeable to have our colleague, Carolyn Maloney, Representative of New York, join us here today. Representative Maloney has indeed shown a great interest in the Federal royalty program for several years now. And her insight and her comments will be very welcome on this Subcommittee.

The question of whether the Federal Government should take its oil and gas royalties "in kind" presents a lot of interesting possibilities. Of course, we are interested in any option that purports to improve services at a reduced cost.

We share the Chair's interest in developing more simple, certain, and efficient methods of collecting oil and gas royalties. We are pleased to learn that a group of the independent oil and gas producers, through their trade associations, is working together to develop a royalty-in-kind proposal; just as we are pleased that the Minerals Management Service, under the able leadership of Ms. Cynthia Quarterman, is aggressively examining the question. The oil-producing states too have a valuable role to play in this discussion.

However, it is a bit unsettling to hear—after aggressive lobbying by the states and oil and gas industry officials, and over the initial objections of the Minerals Management Service—that the Royalty Fairness and Simplification Act of 1996 that was signed by President Clinton just one year ago should be cast aside along with the improvements made to the royalty management program and replaced with an in-kind marketing program. This is almost a 180 degree turn from what the oil industry and states were clamoring for during the last Congress.

To a certain degree, I am being facetious. However, our experience with the Royalty Fairness Act illustrates an important factor to bear in mind. We must all be very cautious and extremely deliberative in our consideration of the radical idea of replacing the traditional in value royalty payment with a royalty-in-kind program.

The Federal Government is the largest single owner of oil and gas resources in the United States. What would be the consequences of changing the Federal role from royalty collector to oil and gas marketer? What safeguards would be necessary to assure that the taxpayers will receive their fair share from the development of our nation's oil and gas resources?

Have we adequately considered the consequences of enabling the Federal Government to dictate market price by virtue of its market power? How would the various segments of the oil and gas industry respond to having the Federal Government in the oil business?

We must know the answers to these and other critical questions before we set about writing and considering legislation. Particularly one of the great concerns is we are going away from government being involved in many activities, and we are now asking the government to get involved being an oil marketer. That is a very, very step going away from where we are trying to go in many other areas.

I think our experience in Puerto Rico has been that the government's participation in businesses that are most appropriately private enterprise is a bad, bad experience. I think probably the worst marketer in the world would be the government. Because, clearly, if it is not handled correctly, a U.S. royalty-in-kind program could seriously disrupt the domestic petroleum markets. So we must move slowly and carefully to fully examine this idea.

We have a great deal of research and analysis to do before we can say with any degree of certainty that royalty-in-kind is better than in-value royalty. And there are others beyond these distinguished witnesses here today from whom we should hear, as our Chair has already indicated.

For instance, none of the major oil and gas corporations are on the witness list here today. I hope we will gain the benefit of their views at the next hearing in September when we will also hear from witnesses invited at the minority's request.

Royalty-in-kind does offer interesting possibilities, but it is no panacea to problems encountered with the current in-value royalty program. Suggesting any specific, mandatory change to the Federal royalty management program at this point in time is premature.

Only after additional study and experience, which MMS can gain through its ongoing efforts and we in Congress can gain through additional oversight hearings, can the subcommittee begin to consider what, if any, changes are necessary to the authorizing statutes. With that message of caution, I join the Chair in welcoming our witnesses today.

[Prepared statement of Mr. Romero-Barceló follows:]

STATEMENT OF HON. CARLOS ROMERO-BARCELÓ, A DELEGATE IN CONGRESS FROM THE TERRITORY OF PUERTO RICO

Madame Chair, we appreciate the opportunity to review the possibilities for a royalty-in-kind program in the Federal oil and gas leasing program.

It is particularly agreeable to have our colleague, Representative Carolyn Maloney of New York, join us here today. Representative Maloney has shown an interest in the Federal royalty program for several years now. Her insights and comments will undoubtedly be of great value to the Subcommittee.

The question of whether the Federal Government should take its oil and gas royalties "in kind" presents many interesting possibilities. Of course, we are interested in any option that purports to improve services at reduced cost.

We share the Chair's interest in developing more simple, certain and efficient methods of collecting oil and gas royalties. We are pleased to learn that a group of the independent oil and gas producers, through their trade associations, is working together to develop a royalty-in-kind proposal. Just as we are pleased that the Minerals Management Service, under the able leadership of Ms. Cynthia Quarterman, is aggressively examining the question. The oil-producing States, too, have a valuable role to play in this discussion.

However, it is a bit unsettling to hear—after aggressive lobbying by the States and oil and gas industry officials—and over the initial objections of the Minerals Management Service—that the Royalty Fairness and Simplification Act of 1996 that was signed by President Clinton just 1 year ago—should be cast aside along with the improvements made to the royalty management program and replaced with an "in-kind" marketing program. This is almost a one-hundred and eighty degree turn from what the oil industry and states were clamoring for during the last Congress.

To a certain degree, I am being facetious. However, our experience with the "Royalty Fairness" Act illustrates an important factor to bear in mind.

We must all be very cautious and extremely deliberative in our consideration of the radical idea of replacing the traditional "in value" royalty payment with a "royalty-in-kind" program.

The Federal Government is the largest single owner of oil and gas resources in the U.S. What would be the consequence of changing the Federal role from royalty collector to oil and marketer?

What safeguards would be necessary to assure that the taxpayers would receive their "fair share" from the development of our Nation's oil and gas resources?

Have we adequately considered the consequences of enabling the Federal Government to dictate market price by virtue of its market power?

How would the various segments of the oil and gas industry respond to having the Federal Government *in* the oil business?

We must know the answers to these and other critical questions before we set about writing and considering legislation.

Because, clearly, if not handled correctly, a U.S. royalty-in-kind program could seriously disrupt the domestic petroleum market. So, we must move slowly and carefully to fully examine this idea.

We have a great deal of research and analysis to do before we can say with any degree of certainty that "royalty in kind" is better than "in value royalty." And, there are others beyond those distinguished witnesses here today from whom we should hear. For instance, none of the major oil and gas corporations are on the witness list today. I hope we will gain the benefit of their views at the next hearing in September when we will also hear from witnesses invited at the Minority's request.

"Royalty in kind" does offer interesting possibilities, but, it is no panacea to problems encountered with the current "in-value" royalty program. Suggesting any specific, mandatory change to the Federal royalty management program is premature. Only after much additional study and experience—which MMS can gain through its ongoing efforts—and we in Congress can gain through additional oversight hearings—can the Subcommittee begin to consider what, if any, changes are necessary to the authorizing statutes.

With that message of caution, I join the Chair in welcoming our witnesses today.

Mrs. CUBIN. Thank you. And now for our first witness, Mrs. Maloney, the Representative from New York. Welcome.

STATEMENT OF HON. CAROLYN MALONEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mrs. MALONEY. Thank you very much, Madam Chairwoman, and other members of the Subcommittee. I appreciate very much the opportunity to testify today. I would like to request that my entire testimony be put in the record as whole, but I have a very, very brief synopsis of it.

The American taxpayer has lost out on nearly $2 billion in unpaid oil royalties since 1980. I appreciate very much the efforts on the part of the Department of the Interior and the Department of Justice toward correcting this debt. However, I do not believe that collecting royalties-in-kind will serve taxpayers well or the Federal Government.

Let me bring you up to date very, very briefly on the oil royalty situation. Last year, it came to the attention of the House Subcommittee on Government Management, Information, and Technology, on which I serve, that several oil companies had significantly underpaid their Federal oil royalties. The information came through the Department of Interior's Task Force on California Valuation.

The task force revealed that the royalties paid were much, much lower than they should have been because they were based on the posted price of the oil rather than the real economic value of the oil. The states who lost out in the undervaluation are pursuing their losses. The State of California won a $345 million settlement from major oil companies. Alaska, Texas, Alabama, New Mexico, and Louisiana have also won settlements.

The Department of Interior and the Department of Justice are both investigating the undervaluation reports. The Department of Interior has issued bills for $440 million in unpaid royalties. And the Department of Interior has proposed regulations on Federal oil royalty valuation, which bases the price of oil royalties on the New York Mercantile Exchange market price and the Alaskan North Slope spot prices, which is a standard oil price that the oil companies use.

This came out in the task force report from the Department of Interior, and this is the basis of price for the oil companies. If it is the basis of price for the oil companies, it should be the basis of price for the Federal Government. Here is the key. Those proposed new regulations would bring in an additional $100 million annually. It is money that is owed to the American people and to the Federal Government.

As you know, the industry is interested in a substitute system. They would prefer to pay the royalties-in-kind. Such a deal would force the Federal Government into the oil business, and it would cost the citizens, the taxpayers money.

Here is what would happen under an in-kind system. Oil companies hand over oil as payment. The Minerals Management Service then contracts out to marketers. The marketers then sell to refiners. The profits from the oil are partially eaten up in paying the marketing costs, and American citizens and the Federal Government get jipped. It simply costs the government too much to get rid of the oil.

Let me give you one example of how this might work. I see that Devon Energy is here to testify today as an oil producer. But what you all might not know is that Devon Energy is also a marketing corporation. The royalty-in-kind proposal gives a company like Devon the option of paying the government its royalties in oil, then being paid by the government to market it.

I don't mean to single out Devon Energy, which is an outstanding company. These practices are quite common in the industry, but they seem downright unfair when oil companies are making money at the expense of hardworking taxpayers.

You have heard and will hear today that the MMS, Minerals Management Service, has changed. You will hear that it is making sincere efforts to change its valuation rules to assure the collection of real value. You will hear that it is working to correct the flaws in its current royalty-in-kind program and to expand and improve that system.

Despite the progress, I don't believe the Federal Government has any business playing J. R. Ewing from the old Dallas television series. The Interior Department does not have the culture, the incentives, or the equipment to become an effective competitor. There are $4 billion in revenues at risk. I encourage other reforms of the Royalty Management Program.

Earlier this year, I introduced the Royalty Collection Reform Act, which would move the program from the Department of Interior to the Department of Treasury to better ensure the collection of money. I believe this is a better solution than shortchanging taxpayers to the advantage of the oil industry.

I would just like to add that last year an important bill was passed out of Congressman Horn's Subcommittee on Government Management and Technology, and I worked very closely with him on this reform. And I just mention it because it is similar in a sense. We did a study that showed $55 billion was owed the Federal Government in loans, fines, fees—this is how we started looking at the royalties—and royalties.

And one of the things that we did to modernize collection is to move collections to a centralized collector whose purpose and focus is collecting money, the Department of the Treasury. For example, the Education Department had many loans that they weren't collecting, but their prime focus and purpose is to educate, not to collect money.

And so if you put it into a collector's hands after a certain period of time where the central agency tries to collect, then they will focus on collecting it as their prime and main mission. So I just mention it. And according to the Department of Treasury, our bill has brought in roughly—they estimate will bring in $10 billion over the next five years.

I would like to put three graphs into the record if I could that point out simply the proposals. This is the royalty-in-kind proposal and the new regulations that MMS has put into effect. The new regulations that they are calling for would have the government royalty based on the market price, which is the price that the oil companies pay.

If it is good enough for private sector, why shouldn't it be good enough for government. The royalty-in-kind proposal will have the government royalty—the market price could be diminished by the marketing expenses and other expenses that may be involved.

This is a graph of how an oil company—many of our large oil companies are integrated and formed. They have a production affiliate, a marketing affiliate, a transportation affiliate, and a refining affiliate. And so there could be built-in costs before we would get the real revenue. It is much simpler to just get the market price.

And, again, I give the current system, which is very simple. You have the oil. You have the market price. You have MMS collecting the market price for the government's oil. Under the royalty-in-kind, you would have MMS becoming hugely involved in marketing to various contractors, to various oil refineries, and there will be a lot of government cost and expense.

And it seems to me as we are working, as we speak on the floor jointly in a bipartisan way to balance the budget and to invest in values and really run government more efficiently that the more efficient way to collect oil royalties is with the market price, the market price that, in fact, serves the private sector. And I thank you, and I tried to be brief, and I——

Mrs. CUBIN. And you did a good job.

Mrs. MALONEY. [continuing] would like to put this in the record.

Mrs. CUBIN. Without objection.

Mrs. MALONEY. And if there are any questions, I would love to answer them. In any event, I look forward to working with you.

[Prepared statement of Mrs. Maloney follows:]

STATEMENT OF HON. CAROLYN B. MALONEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you Madam Chairman and Members of the Subcommittee.

Background

Last year, in a hearing of the House Subcommittee on Government Management, Information, and Technology, the Subcommittee discussed the findings of the Department of Interior's Interagency Task Force on California oil valuation at great length. According to the report, major oil companies underpaid Federal royalties by posting the price of oil below the real economic value of the oil which the companies determined to be the Alaskan North Slope (ANS) spot price.

On September 24, the Committee on Government Reform and Oversight released a report entitled, "Crude Oil Undervaluation: The Ineffective Response of the Minerals Management Service." This report contains three findings that pertain to this hearing: 1) the Federal Government has received oil royalties below market value, 2) the oil undervaluation problem exists nationwide, and 3) the MMS royalty in kind program may have left Federal financial interests unprotected.

Since the release of the Task Force and the Committee report, the Department of Interior (DOI) has proposed new regulations on Federal oil royalty valuation which bases the price of Federal oil royalties the New York Mercantile Exchange (NYMEX) market price and the Alaskan North Slope (ANS) spot price.

Royalty In Kind

As you know, MMS' proposed regulations have produced voluminous comments, especially from industry. A surprising theme repeated throughout the industry comments on Interior's proposal is that the Department should cease collecting royalties in value and take its production in kind, meaning the Federal Government should enter the oil business.

Compare this to the arguments we heard last year in support of the sale of the Elk-Hills Naval Petroleum Reserve. In managing that Reserve, the Department of Energy sold Federal oil. But last year, many of these same industry advocates were arguing that the Department of Energy, as a government entity, simply had no place in the oil business. But today, they urge us to force the Department of the Interior to enter the market on a scale that would eclipse, by several fold, the DOE's Elk Hills program.

It was only last year that this Congress passed into law, the Federal Oil and Gas Royalty Simplification and Fairness Act. This legislation imposed new requirements on the Department of Interior to follow in the collection of royalties. As I understand it, the Minerals Management Service has yet to fully implement these requirements which has caused a flurry of rulemakings, task force groups and other re-direction of resources. Now industry is advocating even more drastic changes—changes, which if implemented in full would essentially scrap these recent reforms.

I believe the real impetus behind industry's royalty in kind push is to avoid paying oil royalties based on market price as suggested in the new proposed oil valuation regulations.

Forcing the government to take the royalty in kind will trap the government in the very posted price system that does not reflect value. Industry believes that bidding the production out at the lease will safeguard the public's revenue interest against posted prices. However, if the real independent producers cannot obtain market value, how can the Federal Government? The fact is that those that could purchase at the lease—the major integrated companies—have an interest in getting access to cheap oil. And those others that more typically participate—brokers and marketers—would not survive if they could not profit from the difference between posted price and real value.

Industry also suggests that MMS use marketing middlemen to sell the government's in kind production. This Subcommittee is fortunate to have oil marketers before it today, and I would urge you to question them closely about how use of marketing middlemen would protect the public's revenue interest.

For example, Devon Energy, which is here to testify in support of a government royalty in kind program, is not only a producer, but a marketer through its subsidiary, Devon Marketing Corporation. Devon's SEC filings indicate that its marketing affiliate has purchased over 80 percent of its production from third parties over the last few years. Logically, it is thus a potential purchaser of the government's royalty in kind production. Those same documents indicate that Devon Marketing purchases third party oil production at the field postings and resells it at a premium over posting.

I do not mean to single out Devon Energy. As I understand it, the practices of its marketing affiliate are common.

But as potential purchasers of the government's in kind production, I would urge the Subcommittee to ask these industry marketers the following questions. Would you follow your normal practice of purchasing product at the posted price for in kind production? And, if not, what percentage of the premium received by your marketing affiliate would you share with the Federal Government and what would you keep as a "marketing fee"?

My concern is simple. In the past, MMS operated its royalty in kind program as a source of cheap oil for independent refiners. The current proposals suggest that the economic advantage of cheap government oil will simply be transferred from small refiners to marketers. Under either scenario, the public's revenue interests are left out of the equation.

I have also heard repeatedly from industry that MMS simply has no understanding of the crude oil market. If it is true that MMS' knowledge lags the market, how can we hope to assure that MMS will on a timely basis be able to evaluate the performance of its marketing agents? And, if it does take five, 10 years for MMS to catch up, as we have seen in the past, what protection will exist that the public will not be short-changed?

In referring back to Interior's task force report, our Committee found example after example of how oil companies were very successful in losing MMS auditors in a maze of oil transactions. Let me quote from the report:

On Page 18, the report states, "Most oil from Federal oil and gas leases is produced by integrated companies that transfer production from their production arm to a trading or refining arm. After this initial non-arm's-length transfer, oil produced from Federal leases loses its identity in companies' accounting systems so that its price in subsequent transfers cannot usually be determined.

And on Page 49-50, the report says, "After transferring Federal crude of a specific type to a company's trading division, the distinction between Federal and non-Federal crude oil was lost. Federal crude oil was not specifically invoiced in companies' records after internal transfers, so it is unlikely that gross proceeds in excess of posted prices can be traced to the production of specific Federal leases."

As much as I admire the efforts of the Secretary to make improvements to Interior's Royalty Management Program, I believe the major oil companies have and can continue to bury the Royalty Management Program audit teams in a maze of company trading transactions. Furthermore, the oil companies have made no secret of their desire to use legal roadblocks and endless appeals to prevent the release of their affiliate's records. That's why I believe that using spot prices like the ANS and NYMEX is by far the most efficient, accurate and least bureaucratic method to value royalty on.

Conclusion

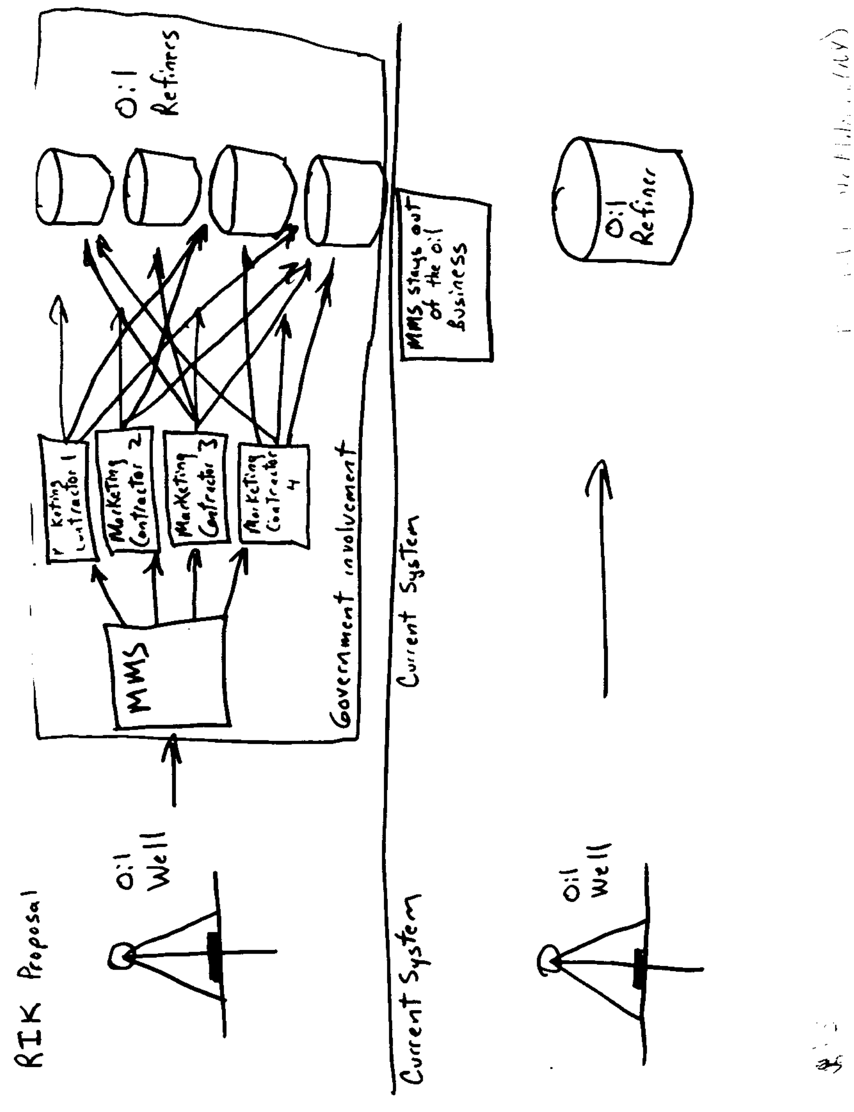
You have heard and will hear today that MMS has changed. It is making efforts to change its valuation rules to assure the collection of real value, and I applaud those actions.

But, despite this progress, I simply not believe that the Federal Government should enter the oil business. The Interior Department does not have the culture, the incentives, or the equipment to become an effective competitor. Congress should not risk $4 billion in revenues by forcing MMS to try and recreate itself into something that in reality it cannot effectively become.

Reform at MMS is possible. I too have called for further reforms of the Royalty Management Program. I have introduced the Royalty Collection Reform Act, which would move royalty collection to the Department of Treasury's Financial Management Service (FMS) to better insure that funds owed the government are collected. FMS can collect Federal royalties accurately without the need for a full blown oil royalty in kind program.

Thank you.

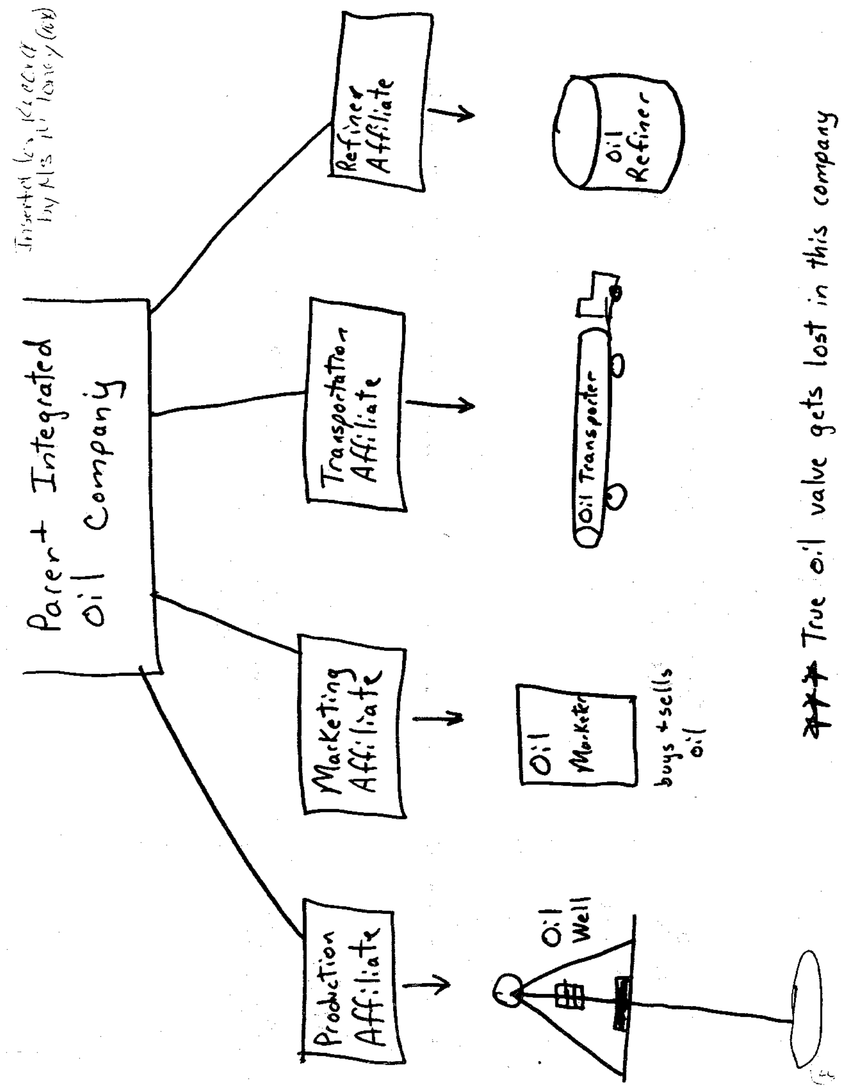
[Graphs follow:]



RIK Proposal
Oil Well
MMS
Marketing Contractor 1
Marketing Contractor 2
Marketing Contractor 3
Marketing Contractor 4
Oil Refiners
Government involvement
Current System
Current System
Oil Well
MMS stays out of the oil Business
Oil Refiner

Inserted for Record by Mrs Maloney (NY)

RIK Proposal	Government Royalty = Market Price − Marketer Profit & Expenses
New Regulations	Government Royalty = Market Price


Parent Integrated Oil Company
Production Affiliate
Marketing Affiliate
Transportation Affiliate
Refiner Affiliate
Oil Well
Oil Marketer
buys + sells oil
Oil Transporter
Oil Refiner
True oil value gets lost in this company

Mrs. CUBIN. Thank you. I do have just a couple questions. First of all, I know that you know this, but just for the record, when Federal minerals are produced in a state, then the state shares in the royalties at 50 percent.

And so before I came up here today, I think want to say this because I want you to understand—not just you but everyone to understand—how not only do I think it is the right thing to do to collect the appropriate penny of the appropriate amount—every single penny that is owed to the government in royalties, but it is also for every constituent in my state.

Because I went back and looked up the data published by MMS on all the royalties collected from Federal leases within each state since the advent of the Mineral Leasing Act, and it may surprise you to learn this that New York has had natural gas production from Federal mineral estate totaling $54,327 in royalties from 1920 through 1995.

Now, let us compare that with the total of royalties paid into the Treasury from the Federal leases in Wyoming over the same period of time. According to MMS, over $6,680,000 of royalties were paid from Wyoming, and so, obviously, our schools and our communities, our highways—it is very important to me that we get every single penny to which we are entitled. And we agree very strongly on that.

There may be some disagreement. I think that is yet to be told. But I want to ask you this question. Did your graphs show the amount of money that the Federal Government spends on litigation, on enforcement, and audits, and all of those kind of things—expenses that go into the current collection process?

Mrs. MALONEY. Well, we hope the regulations will fix some of that. My graphs had no numbers on them at all. And as you know, their new regulations greatly simplify their collections process, projecting to collect on the Alaskan North Slope prices and the New York Mercantile Exchange, as opposed to the posted prices.

I would think that moving to that system would cut out a lot of litigation just by common sense, that there is nothing to litigate. I mean, it is very clear. Here is the price that the private sector pays. Here is the price that the government pays. It is the same.

Mrs. CUBIN. Well, unfortunately, it really isn't that simple. I live right in the middle of an oil and gas field, and the problem that I see at this point in time with the proposed rule is that what this rule will do is move the point of valuation farther from the wellhead or from the border of the lease.

And so that the price then will include some beneficiation rather than the actual price at the wellhead, and that is where the tax ought to be assessed, in my opinion. You said that $51 billion or $55 billion is owed in uncollected royalties. Is that correct?

Mrs. MALONEY. That was to illustrate centralizing collections in the Treasury. This report that we did was one of 100 agencies where they reported back what was owed to them, and this was not just an oil report. This was all that was owed the Federal Government in uncollected——

Mrs. CUBIN. In minerals?

Mrs. MALONEY. No, no, no, in everything.

Mrs. CUBIN. Oh, OK.

Mrs. MALONEY. In everything—education, agricultural loans, small business loans, loans, fines, fees, royalties, and other areas. This was what was owed to the Federal Government that was not collected. And Congressman Horn and I put in a bill to improve collections, not just for royalties but across the government, that modernized it, simplified it, and, very importantly, put collections in one office whose mission it was and focus was to bring revenue into the Federal Government.

Mrs. CUBIN. Thank you.

Mrs. MALONEY. And that has helped bring in—in fact, we are working on our second report, and I will be glad to share it with you with Mr. Horn of what has come in since our bill went into effect. But the Treasury projects that having done what we did, centralizing collections in Treasury, will improve collections across our government by they said $10 billion in 5 years. That is a lot of schoolteachers. That is a lot of police officers. That is a lot of investment in the interior and other things in our parks that we need money for.

I just mentioned that as a way of possibly improving collections instead of having the Department of Interior that has so many important responsibilities to possibly let the Treasury Department, which is collecting now across government, likewise collect royalties. Maybe that is another issue maybe that is not just in-kind, but I just brought it up since it had been successful in bringing in revenue. And that is one of the focuses of the in-kind hearing that you are having now, to bring in the revenue. In any event, I appreciate your time and of all the members here.

Mrs. CUBIN. Thank you. Did you have any questions, Mr. Barceló?

Mr. ROMERO-BARCELÓ. First of all, I would like to thank Mrs. Maloney for her testimony and for being here with us——

Mrs. MALONEY. Thank you, Governor.

Mr. ROMERO-BARCELÓ. [continuing] and helping us and educating us. She knows more about this problem than I do. I am just beginning to learn about it. But, Madam Chair, I would like to suggest that we ask for the Administration to give us an estimate on the cost of litigation for the collection of the——

Mrs. CUBIN. Certainly.

Mr. ROMERO-BARCELÓ. OK. Thank you. Thank you, Madam Chair. And I just have a couple of questions for Mrs. Maloney. Do you know what has been the experience in those countries like Venezuela and Mexico where the government is involved in the business of marketing oil?

Mrs. MALONEY. I have not studied those countries. I could look at it and get back to you.

Mr. ROMERO-BARCELÓ. Well, the experience is very, very, very bad for those countries. I mention that because everywhere that the government gets involved in something that is capitalistic as marketing, they are never successful.

So if that is an option, this will be analyzed from all angles because it is very—as I said, the experience that we have had also in Puerto Rico has been a very bad experience. What they had in England and other countries has also been very bad when the government gets involved in selling goods or services.

The other thing I would like to ask you, Mrs. Maloney, is have you been in touch with the Secretary of the Treasury or with anyone in the Federal Management Service about how they would go about it and whether they would be interested in handling the services of collecting the royalties?

Mrs. MALONEY. Absolutely. I have talked several times with Cynthia Quarterman and also with Secretary Babbitt, and I applaud the Administration. They really appointed a task force that came forward with the first government report that showed the undervaluation and took steps to correct it. And I think that they have been innovative, and they have worked very hard on it, and that they have done something constructively to correct a problem. And I applaud them for their efforts.

Mr. ROMERO-BARCELÓ. I am talking about the suggestion that you made that the collection of royalties be delegated to the Department of Treasury, not the Interior.

Mrs. MALONEY. I have talked to Treasury officials, but I have not met with the Secretary, and I will try to meet with the Secretary and discuss it with him and see what his viewpoints are on it. And I put forward the proposal only with the deepest respect of the Department of Interior and the fine job that they are doing but in probably helping with the management.

What we are doing across government is each agency will have 6 months to collect what is owed to them. Then it moves to the Department of Treasury where they then centralize it and try to bring it in through a centralized method, which has been working very well.

Mr. ROMERO-BARCELÓ. I just asked that question because the idea to me seems very good because, obviously, the Treasury Department is much more trained to collect any kind of taxes or royalties than anybody else in the government. So——

Mrs. MALONEY. I think that a lot of times in government we are very shortstaffed, and we don't have enough time or energy or personnel to do all the many things that we need to do. And a lot of times your main focus is that of your main purpose which in the Department of Interior is our resources, our parks, our minerals, our oils, and not necessarily the management.

And perhaps that would be a way, but I would, you know, of course, want to work with Secretary Babbitt. I think he has done an absolutely extraordinary job, and I might add that even though there have been published reports about undervaluation of oil for many, many years, this was the first time the Department of Interior appointed a task force, issued a report, then acted on the report's recommendations constructively to correct it.

And I think they have done—I think that I am going to recommend them for one of Vice President Gore's—what are they—the Hammer Awards for government employees who do a good job because I think they have done a wonderful job with those.

Mr. ROMERO-BARCELÓ. Thank you, Mrs. Maloney.

Mrs. MALONEY. Thank you.

Mrs. CUBIN. Mr. Thornberry, did you have—Mr. Brady? Mr. Dooley?

Mr. DOOLEY. Yes. Mrs. Maloney, before you leave, I just wanted to ask one question. I appreciate all the work you have done.

Mrs. MALONEY. The last time I saw you you were on the floor.

Mr. DOOLEY. I know it.

Mrs. MALONEY. Now, you are back up here. I think when I left my office you were on the floor giving a good speech.

Mr. DOOLEY. That is right. But, you know, a lot of it is appreciated—a lot of the work that you have done in terms of ensuring that taxpayers are getting their fair share of the royalties. I guess I come at this representing a lot of independent producers, and we are a little bit concerned with some of the proposals in terms of how are we going to ensure that the price is going to be reflective of the real price if they are being paid for their product.

And as I was reading your testimony, I was somewhat struck because it seems like there is one sentence in your testimony that almost expresses a similar concern, and when you were talking about how the in-kind will be difficult because you are concerned you will not be able to safeguard the public's revenue interest against posted prices, you go on to say, however, if the real independent producers cannot obtain market value, how can the Federal Government.

And my concern is is you are making a statement there that independent producers are not necessarily receiving what will be the fair market value, which MMS and I think which you are proposing will be reflected by an ANS price if you are from California, as I am. And some of us are not convinced that that is actually going to occur. In your statement, you state that they are not receiving that now.

Now, I hope that you are sensitive as we try to move forward, you know, to make sure that that price of which the independents are going to be paid on for their royalties are going to be a function of is, in fact, the price that they are receiving for the oil. And do you acknowledge—is this a problem? I mean, it seems to be as you have stated in your testimony.

Mrs. MALONEY. I agree absolutely, completely, Congressman, and, in fact, many independent producers have written my office and actually have come by personally to see me in support of the work of the Subcommittee on the valuation of oil.

Mr. DOOLEY. So would that mean that you would then be opposed to what MMS is proposing in terms of using a benchmark at ANS for independent producers?

Mrs. MALONEY. No. I think that you need to—the independent producers want the true value of the oil. Right? And that is the value that we want, which is the——

Mr. DOOLEY. They want to pay royalties on the price of the oil—on what they are being paid for the oil that they are selling?

Mrs. MALONEY. Right, exactly, exactly.

Mr. DOOLEY. Well, what you are saying in your testimony is that sometimes they are not receiving what the fair market price is and which we are assuming that what MMS is proposing is that the fair market price will either be a New York Exchange price or an ANS price?

Mrs. MALONEY. Yes.

Mr. DOOLEY. And so, you know, my concern is if you are acknowledging they are not getting paid that fair price now, we are going to implement a system which is going to ensure that they are paying higher royalties than what they should.

Mrs. MALONEY. Well, we should separate the independents from the majors in the regulations.

Mr. DOOLEY. Thank you.

Mrs. MALONEY. But, you know, what we looked at in our committee which was getting the best price for the American taxpayer. And the task force showed that the price that the oil companies themselves were paying was Alaska North Slope in the case of California, or the New York Mercantile Exchange for the others. I am not an expert on the oil industry. We were not looking at it except for in a management role, which is the role of the committee.

I do know that several independent producers from California and other states came to my office in support of having a system that was not posted prices but, in fact, Alaska North Slope. So they did, you know, support that work. And whatever their concerns are, I would like to listen to them even more.

But in terms of the work of the committee and the reports coming out of MMS and the proposed system that MMS has suggested in the regulations, the ones that came to my office were totally supportive of it. Now, if there are other independent producers who have a different problem, I am not aware of it.

And as you pointed out, I don't represent an oil state. I was not coming at it from a state interest. I was coming at it from the purpose of the committee on which I serve, which is better management of government resources and reports that come forward that oil is greatly undervalued and that California, Wyoming, and others—in fact, it was California that the whole issue really highlighted out of the collection system of the State of California.

Mr. DOOLEY. Well, I think most of the independents or representatives of their associations have come out in opposition and expressing some real concerns about the valuation process; at least that is what the associations are communicating to me. The other point I would make is——

Mrs. MALONEY. What is their problem with the valuation process?

Mr. DOOLEY. Well, precisely what you said in your testimony. I mean, what you stated in your testimony was, however, if the real independent producers cannot obtain market value, how can the Federal Government. You have made a statement that independent producers are not obtaining fair market value. What MMS is proposing is that fair market value can be determined by an ANS benchmark. And you have already acknowledged that that is not happening.

And so my concern is that you are stating in your testimony that my guys, my independent producers are going to be paying a higher royalty than what they should based on what they are receiving for the oil that they are producing, and that to me is an inequity that we need to be concerned about.

Mrs. MALONEY. We agree some of the independents feel that the majors give them an inequity, but, again, we were acting on the report of the task force that said the majors—and the task force report focused on majors, not the independents—said that the major oil companies—10 to be exact—were basing their prices internally on Alaskan North Slope and the New York Mercantile Exchange, and that the posted prices were much lower than those two standards.

If independents—you know, maybe there should be separate regulations for the independents given the specific problems that the independent oil companies have. And I would like to go back and meet with some independent oil companies and become more aware of their particular problems.

But, as I said, you know, I am not the Department of Interior. We were looking at a report that oil was greatly undervalued, and we acted on it. But you raised an important point, and I agree with the great Congressman from the great State of California, which actually brought this attention to the national level in the first place.

Mr. THORNBERRY. [presiding] Mr. John, you have something?

Mr. JOHN. Yes. I don't particularly have a question for the gentlelady from New York, but with the pleasure and the OK of the Chairman, I would like to make just a little observation, a little statement about the importance of this issue.

Being from Louisiana, oil and gas industry is very, very important. As I served in the legislature, $1 billion in royalties is part of the Louisiana budget for the State of Louisiana. So this issue is very, very important.

And, moreover, than just the State of Louisiana, my district, which sits on the Gulf of Mexico and bordered by the State of Texas, is what I like to call the heartbeat of the offshore oil and gas industry of the Upper Gulf of Mexico. So this issue is very important and very vital to my constituency, the oil and gas industry, and the taxpayers of the State of Louisiana.

I think we must keep in mind as we go through these proceedings that I believe the bottom line, and to make it as simple possible, is that we need to look at the cost associated with the proposed system and the systems already in place. What does it cost MMS now to evaluate the problems that are caused, and what is the value? Is it wellhead or is it whatever? Or what is it going to cost to revamp a collections agency to go toward the in-kind.

So I think if we keep that in mind, that is the ultimate decision that this Committee is going to have to do and decide upon. So I just wanted to make a statement that it is very, very important to my district in my State of Louisiana. And I thank the Chairman of the Committee for holding these hearings. Thanks.

Mrs. MALONEY. Well, I thank you. And many of the attorney generals of the states that many of you represent that are oil-producing states have been in contact with our offices and the central committee, most of whom are supportive of our efforts to revamp the system.

Mr. JOHN. Well, this issue, like many others, has its proponents and opponents, but I am anxious to hear the gentlemen from the—or the testimony from the State of Texas that actually has an in-kind program in the state on state waters and state lands to see how it is working. I think I am interested in hearing that testimony. Thanks.

Mrs. MALONEY. Well, I look forward to reading about it too. Thank you very much. I appreciate your time.

Mr. THORNBERRY. Mrs. Maloney, thank you for your testimony. And certainly if your schedule permits, we would certainly invite you to stay and sit up on the dais and listen to the testimony from the State of Texas where they have had such a program since 1973. I think it would be helpful for everyone.

We would call the next panel now; Jim Magagna, Director, Office of State Lands and Investments, Office of Federal Land Policy, State of Wyoming; Spencer Reid, Deputy Land Commissioner, Texas General Land Office; and David Darouse, Mineral Revenue Regional Auditor Supervisor, Department of Natural Resources, from Baton Rouge, Louisiana.

Gentlemen, we appreciate each of you being here today and willing to share your perspectives with us on this issue. Mr. Reid, we will let you start, and we will just go down the line from our right to left.

STATEMENT OF SPENCER REID, DEPUTY LAND COMMISSIONER, TEXAS GENERAL LAND OFFICE

Mr. REID. Mr. Chairman and members, Texas Land Commissioner Garry Mauro appreciates the invitation to appear before the Subcommittee today and to discuss the Texas royalty-in-kind program and regrets that he is unable to personally attend, and he has asked that I speak on his behalf.

One thing I would like to point out is we were asked to bring comments about our experience with our program, and these comments are not intended to address any particular proposals that are pending. We haven't addressed anything in here like that.

We have been very pleased with the results of our in-kind programs and are glad to share this information. While royalty-in-kind may not cure all of the disputes that arise between royalty owners and producers, our experience in Texas has been that it does provide a means to substantially reduce royalty disputes, valuation disputes particularly, reduce costs to both the states and the lessee, and provide the royalty owner with an opportunity to obtain an enhanced return.

For those of you not familiar with the Texas General Land Office, it is headed by an elected state official. The principal duty he has is to manage 20 million acres of state lands of which about 15 million have minerals under them, of that about 5 million is offshore of Texas either in the Gulf of Mexico or in the various bays of the state.

And all of the land there is dedicated to the Permanent School Fund or one of the Permanent University Funds. The Permanent School Fund last year—the General Land Office deposited about $155 million, which I know in Federal standards isn't a lot of money, but for Texas that has allowed us to build on a fund now approaching $14 billion for support of public education in Texas.

There is also the Permanent University Fund in Texas that has another—it has got over $5 billion that is operated by the University of Texas. It has a lot of land out on Permanent Basin. As to the relative size of our production, we have about 33 billion cubic feet of natural gas, which if Texas were a producer in its own right would put us in probably the top 50 producers in the country.

The Texas program has been going on for about 14 years. It has accelerated in the recent years. Over that time, we have enhanced our income to the Permanent School Fund by $11 million in gas and $5 million in oil. And another component of the state program which is something that really is kind of the gist of our program, we save state agencies in Texas over $90 million over that same period of time in energy costs by selling them state gas from state leases directly to state consumers.

Our in-kind program originated in the early 70's. The legislature passed the first statutory authorization for the program in 1973. From then until the early 80's, we took relatively small volumes of gas and sold them in the marketplace just like a marketer.

In 1983, we began marketing gas directly to end-users, and by the end of 1985, it was expanded to include state agencies. This expanded programs concentrated on sales to agencies, universities, and public facilities. The goals of the program were twofold: first, to generate more revenue to the Permanent School Fund and to save money for the state agencies.

The Texas legislature has consistently supported the program and in recent years has enacted laws that assured the smooth operation of the state program. Any state agency contract for over 100 Mcf of gas per day must be submitted to the General Land Office to see if we can provide state gas and get them a better price. And then we are able to transport gas and gas utility lines. They are prohibited from—well, they are required to carry state gas if they have capacity if it is destined for a state agency.

In addition to the natural gas in-kind program, the Land Office takes approximately 2,400 barrels of oil per day and sells it in-kind. That is 45 percent of our total production, our total royalty share. The oil is sold under 6-month contracts at bid sales. Prices are bid at premiums to posted prices, and at the last sale in April, the premium was as high as $2.08 over the commonly used posting.

Last fiscal year, the gas program sold approximately 9.1 Bcf to state agencies and 2.6 Bcf were sold on the spot market. Our total gas sales represent about 35 percent of our total production—our total royalty share, let us say. Our spot market sales assure that adequate supplies have been retained to meet our state end-user program. Gas is currently being taken in-kind from 105 leases, almost all of them offshore.

The contracts are in place with 103 state facilities, 28 state colleges and universities, and six other governmental bodies, including school districts, small cities. Transportation contracts are currently maintained with 35 different pipeline companies and local gas distribution companies. And we maintain a contract for up to one Bcf of gas storage in a facility near Houston.

Sales of gas on the spot market are sold through monthly solicitations of interest from prequalified gas marketers. We currently have about seven marketers that bid on this. In order to qualify, marketers must show financial stability. But in order to encourage small business participation, the Land Office maintains a credit risk insurance for those contracts.

Since 1973, all state oil and gas leases have provided for the right of the state to take royalty-in-kind upon 60 days' notice of our intent to do so. On some leases, we have been able to negotiate in-kind those that were issued prior to 1973.

Once we have exercised our right to take-in-kind for a particular lease, we make every effort to continue to take gas from the lease in order not to burden the lessee by alternately taking and not taking. We do have the authority to not take. We generally take possession at the point in which it has been made ready for sale or commercial use through the removal of water, natural gas liquids, and impurities.

Costs of transportation and other direct costs, together with the markup or enhancement, which is what the additional royalty paid the school funds is termed, and a set administrative fee that pays for our operating costs of the program are charged to the gas purchasers—the end-user purchasers.

In all but a few cases, prices to the end-user agency are below those available from private sources and are lower than local utility costs in almost every instance.

We make a decision at every sale and the local—the agency is authorized to not buy from us if it is going to cost them money.

Gas and oil producers on state lands have almost been uniformly supportive of both the gas and oil in-kind programs. We don't have specific figures on the administrative savings and other benefits, but they are undoubtedly there. It is a lot easier to account for volumes of oil or gas physically delivered than to account for both volumes delivered and the market value of those volumes.

Delivering in-kind relieves the producer of the obligation to account for the market value of the gas and relieves the Land Office from the burden of conducting the financial audits of producers. Once accurate delivery is established, the producer no longer needs to be concerned state auditors will dispute the value that they received.

Our programs are so successful we are looking at privatization of our programs or bringing in a gas marketing firm. We put out a RFP last summer. We have gone through the process and got down to the company that we are negotiating final contract with.

The contract provisions provide that we are negotiating for an expansion of our end-user program. They will take a three cents fee for doing that activity. And then the balance of it, if we have overages, essentially works out to a gas sales contract indexed to a pipeline.

I will close by just saying that Texas is very interested in a way to obtain its share of Federal royalties that were paid in-kind. Volume is the name of the game in this business, and we would be very anxious to work with Congress and Interior staff to see if a way can be worked out to do that.

[Prepared statement of Mr. Reid follows:]

STATEMENT OF SPENCER REID, DEPUTY LAND COMMISSIONER, TEXAS GENERAL LAND OFFICE

Ms. Chairman and Members:

Texas Land Commissioner Garry Mauro appreciates the invitation to appear before you to discuss the Texas royalty in-kind program, and regrets that he is unable to be here. He has asked that I speak on his behalf.

The Land Office has been pleased with the results of our in-kind programs and are glad to share information about them with you. While royalty in kind may not cure all of the disputes that arise between royalty owners and producers, our experience in Texas is that it does provide a means to substantially reduce royalty disputes, reduce costs to both the State and the lessee, and provide the royalty owner an opportunity to obtain an enhanced return.

For those of you not familiar with the General Land Office, please allow me to briefly explain our role. The Land Commissioner, who heads our agency, is an elected official. One of his main duties is to manage the more than 20 million acres of public lands and minerals owned by the various Texas government departments, most prominently, the Permanent School Fund, a trust fund that supports public education in Texas. In the fiscal year ending August 31, 1996, $155 million were deposited in the Permanent School Fund, which, although not large by Federal standards, has nonetheless allowed Texas to create a school endowment worth over fourteen billion dollars. The State's Permanent University Fund, which is similarly structured, is valued at over five billion dollars. As to the relative size of State production, the approximately 33 billion cubic feet of natural gas that represents our annual royalty share would rank the School Fund in the top 50 of the largest producers of natural gas in the United States.

Over the past fourteen years, the Texas in-kind program has enhanced royalty income for our Permanent School Fund by over $11 million in gas royalty and $5.1 million in oil royalty, saved State agencies over $90 million in gas utility bills, and saved untold thousands of dollars for the General Land Office and oil and gas producers by eliminating the need for financial accounting for royalty volumes of oil and gas taken in-kind. The program's past success has led me to seek to expand the program through a new public private alliance that I will describe for you in a few minutes.

The Texas in-kind program originated in the early 1970's. The Texas Legislature passed the first statutory authorization for the in-kind program in 1973. From then until the early 1980's, relatively small volumes of gas were sold in the market to obtain better prices than were being paid in cash royalties. In 1983, the General Land Office began marketing gas directly to end-users and by the end of 1985, the program was expanded to include State agencies.

This expanded program has concentrated on sales to State agencies, universities, and other public facilities. The goals of the program are twofold—first, to enhance income to the Permanent School Fund, the principal beneficiary of State royalty income. The second goal is to reduce gas costs to State facilities by providing State gas at prices below those charged by gas utilities.

The Texas Legislature has consistently supported the program and, in recent years, has enacted laws that assure the smooth operation of the State program. One such statute requires all State agencies that consume at least an average of 100 Mcf of gas per day to submit all gas acquisition contracts to the General Land Office for review. If the Land Office is able to provide gas at the same or lower cost, it may require the agency to purchase gas from it. Another supportive statute requires all regulated gas utilities to provide transportation of State gas if capacity is available on their systems and it is destined for a state agency. These transportation rates are competitive with those provided to private parties.

In addition to the natural gas in-kind program, the Land Office takes in-kind approximately 2400 barrels of oil per day. This oil is sold under six-month contracts through a sealed bid auction. Prices are bid at premiums to posted prices. At the last sale, held in April, these premiums were as high as $2.08 over one commonly used posting.

Last fiscal year, the gas program sold approximately 9.1 Bcf of gas to State agencies and another 2.6 Bcf on the spot market which represented 35 percent of our total royalty production. Spot market sales assure that adequate supplies have been secured to meet State end-user demand. Gas is currently being taken in-kind from 105 leases, almost all of which are located along the coast. Sales contracts are in place with 103 State facilities, twenty-eight State colleges and universities, and six other government bodies, including school districts and small municipalities. Transportation contracts are currently maintained with thirty-five different pipelines and local gas distributing companies. We also maintain a contract for up to one Bcf of natural gas storage at a facility near Houston.

Sales of gas on the spot market are made through monthly solicitations of interest from pre-qualified gas marketers, of whom there are currently seven. In order to qualify, marketers must show financial stability. In addition, to encourage small business participation, the Land Office maintains credit risk insurance.

Since 1973, all State oil and gas leases and statutes have provided for the right of the State to take royalty in-kind upon sixty days notice of our intent to do so. On some leases issued prior to 1973, in-kind takes have been provided for by agreement. Once we have exercised our right to take in-kind for a particular lease, we make every effort to continue to take gas from that lease in order not to burden the lessee by alternately taking and not taking. We generally take possession of the gas at the point at which it has been made ready for sale or commercial use through the removal of water, natural gas liquids, and impurities.

Costs of transportation and other direct costs, together with a markup or "enhancement" and a set administrative fee are charged to the gas purchasers. In all but a few cases, prices to the end-user agency are below those available from private sources, and are lower than local utility costs in almost every instance.

Gas and oil producers on State lands have been almost uniformly supportive of both the gas and oil in-kind programs. Although I do not have specific figures, the administrative savings and other benefits to both producers and the Land Office are clear. It is far easier to account for volumes of oil or gas physically delivered than it is to account for both the volumes delivered and the market value of those volumes. Delivery in-kind relieves the producer of the obligation to account for the market value of the gas and relieves the Land Office from the burden of conducting financial audits of producers. Once accurate delivery is established, the producer no longer needs to be concerned that State auditors will dispute the prices that the producer received.

The in-kind programs have been so successful that we are now, as I mentioned, starting the process of revising and more than doubling the gas program. The changes in the natural gas marketplace in the past several years have made it possible, I believe, to form a public/private alliance with a gas marketing firm that will bring the very specialized expertise of that kind of operation together with the gas supply and markets that my office can provide, to the benefit of both the State and the private company.

Last year, we invited over 60 gas marketing firms to submit initial proposals to the General Land Office for just such a public-private alliance. In the invitation, firms were asked to propose plans for their management of our end-user program, the creation of a natural gas liquids sales program, and to purchase the balance of our natural gas supply, approximately 15 Bcf per year at a price linked to the market price, and preferably at a premium. As a result of the responses to that invitation, a marketing firm was selected to begin finalizing a marketing contract by next fall.

It is in this context that the State of Texas is interested in a way to obtain its OSCLA share of production allocated to the States. The name of the game in gas marketing is, of course, volume. These 8(g) volumes are approximately 11 to 15 million cubic feet per day. We would be anxious to work with Congressional and interior staff to accomplish this task.

We believe that in-kind royalty is worth the consideration of any royalty owner that has the opportunity to take marketable volumes of oil or gas or has the opportunity to join with other royalty owners or producers in marketing significant volumes.

Mr. THORNBERRY. Thank you, Mr. Reid, and I failed to mention that without objection each of our full statements will be made part of the record. We will have a vote in just a moment, but for now we would like to continue, Mr. Darouse. I think we have certainly got time to have your statement in, and we will see how we get from there. We have got 15 minutes before we have to be over there.

STATEMENT OF DAVID DAROUSE, MINERAL REVENUE REGIONAL AUDITOR SUPERVISOR, DEPARTMENT OF NATURAL RESOURCES, BATON ROUGE, LOUISIANA

Mr. DAROUSE. Thank you, Madam Chairman, and good afternoon. My name is David Darouse. I work for Secretary Jack Caldwell at the Louisiana Department of Natural Resources. He is unable to attend today so I am here at his behest. The purpose of my testimony today is to explain and summarize our written testimony that we submitted earlier in the week and expound upon it and answer questions as time permits.

It is obvious from our written testimony that we feel that in Louisiana, at least, there are certain legislative impediments that do not allow the state to take oil and gas in-kind and receive the maximum price that it could, and those are laid out in our written testimony.

But let us assume for discussion purposes that these impediments were not in the way and look at how a program would operate. There are certain things that we need, to have a successful take-in-kind program, and we also need to look at how success of such a program would be measured.

One thing that we need are large volumes of oil and gas concentrated geographically in one area so that we can move these volumes to an aggregation point at low expense, to where we can extract the maximum price possible by selling to third parties.

In the 8[g] area, unfortunately, Louisiana participates in about 35 or 40 leases that are spread out from the Louisiana-Texas border—literally laying on the border—all the way to the Louisiana-Mississippi border over in Chandeleur Sound.

Out of those 35 to 40 leases, we have really only 20 or 25 that are major-producing leases, and, again, they are spread out—not randomly—some are aggregated in certain areas—but more or less randomly across that strip of water. So we don't really have the concentrated geographic volumes that we can easily and inexpensively aggregate and move to a market and sell at a premium price.

But considering that we did have the concentrated volumes, which may occur some day, how should we measure the success of a potential take-in-kind program? One important criteria would be to measure the net revenues from a take-in-kind program against the existing royalty-in-value program that we have currently.

Net revenues would be defined as the gross revenues from a take-in-kind sale less the additional costs that will occur in getting that sale, and we have laid out a number of services: experts, forecasters, consultants, that we feel like we would have to have. Maybe not all of these but certainly some would have to be added to staff, either hired for the state to work for us or hired as contractors.

Let us look at the current oil—not regulations—we don't have regulations in Louisiana—but how we are currently enforcing our oil leases in Louisiana. The program that we have in place is to value oil that is sold nonarm's length, not oil that independents or anybody sells to a third party, but oil that is sold nonarm's length to an affiliate or marketing arm of the producer, for value of that oil at what we call market price which we determine as either the Empire Louisiana spot price or the St. James Louisiana spot price, depending on whether we are looking at heavy oil or light oil.

Those prices are published by several major publications who survey those markets on a daily basis. The publications are well-known. Platt's Oilgram is one. Bloomberg's Oil Buyer's Guide is another. So in situations where the oil is sold nonarm's length, we are currently getting royalty-in-value or trying to get royalty-in-value by assessing those values against the values currently reported.

We are getting market value currently. We feel like on oil—like we are getting on oil or we are trying to get market value on oil. If we went to an in-kind program by taking oil in-kind, we feel like in the best situation, a competent marketer striking a competent deal on any given day can only get the price that we were getting currently at Empire and St. James. That doesn't even consider the additional marketing cost.

So we feel like oil take-in-kind would basically be a no-go for the state in the 8[g] zone or on state leases. On gas, we feel like an opportunity does exist for the state or the MMS to make money by marketing gas themselves. There are currently no spot prices across the country and specifically across Louisiana other than one location at the Henry Hub that gas value can be pegged to.

So in situations where we don't know what the value of natural gas is due to interaffiliate transfers, by taking gas in-kind and selling it and aggregating it on the open market, then that is a possible moneymaker for the state and we feel like also for the Federal Government.

We commend the MMS for the past years of starting a pilot program back in 1994 which, although it was not revenue neutral, obtained many valuable lessons for the Minerals Management Service to apply in future take-in-kind programs.

We also applaud the MMS for having outreach programs over the last year where they have held meetings across the country soliciting input from various constituents such as states and industry. And we think they are heading in the right direction by realistically investigating potential R-I-K programs. And with that, I will conclude my comments.

[Prepared statement of Mr. Darouse may be found at end of hearing.]

Mr. THORNBERRY. Thank you, sir. I appreciate it. Mr. Magagna, we will go ahead and let you. I believe we have time to get your statement in if you would like to proceed in that way. When we come back, we can start with questions.

STATEMENT OF JIM MAGAGNA, DIRECTOR, OFFICE OF STATE LANDS AND INVESTMENTS, OFFICE OF FEDERAL LAND POLICY, STATE OF WYOMING

Mr. MAGAGNA. OK. Thank you, Mr. Chairman. I am Jim Magagna, Director of the Office of State Lands and Investments for the State of Wyoming. I want to take this opportunity to applaud the initiative of Chairman Cubin in providing this important dialog for the royalty-in-kind issue.

The State of Wyoming, under our Governor Jim Geringer, has assumed a leadership role, we believe, in seeking development and implementation of a cost-effective and efficient royalty-in-kind program providing an opportunity for full participation by affected states. We appreciate this opportunity to share our efforts and our expectations with members of the Subcommittee.

As I have indicated in my written testimony, part of Wyoming's initial effort to look at the option of a royalty-in-kind program certainly and admittedly has been driven by our frustrations with the current value based Federal royalty program. The Chairman earlier provided figures as to the tremendous amount of revenues and level of dependence that the State of Wyoming has on this.

And since the initiation of net receipt sharing in 1991, we have been frustrated in our efforts to truly define what are the costs of administration that are being borne in part by the State of Wyoming through the deduct from our gross royalty revenues.

We were further frustrated when the Minerals Management Service announced a devolution proposal nearly 2 years ago and then quickly withdrew that proposal. We did work very closely with the Administration and with Congress in the development and passage of the Federal Oil and Gas Royalty Simplification and Fairness Act.

While we think it represented in many areas an important step forward, it was still very limiting from our perspective in the delegable functions which were recognized for the states. And it provided far greater secretarial discretion in delegation than we had hoped for. However, we do continue to work with Minerals Management Service in developing standards and guidelines for the implementation of this Act.

To comment only briefly on the valuation issue, we recognize and share concern that there are problems with the current system with valuation as it applies to non-arm's length transactions, and we applaud the Minerals Management Service for their efforts to address this. However, we feel that the attempt to impose a single index type figure based on the NYMEX or some simpler guideline does not apply to the situation that exists in Wyoming.

We have a unique situation here today with the completion of the Express Pipeline which will suddenly bring an additional 140 to 170,000 barrels of oil a day from Canada into Wyoming, some of which will stay in the Rocky Mountain region refineries.

What we have seen already in three short months of experience with that indicates that the impact of an activity like that on the market available to producers operating in Wyoming is very diverse from its impact on a national market as expressed by an index such as the NYMEX. We have seen some significant price declines in Wyoming as a result of this increased foreign supply that simply have not been reflected in the NYMEX or other standardized measurements to date.

But Wyoming is driven every bit as much by the opportunities for revenue enhancement that we see in the royalty-in-kind program, and we recognize that with those opportunities comes risk. We as a state are prepared to assume those risks that are associated with the private sector in the marketplace and that are necessary if you are to achieve the rewards that can be associated with that.

As a first important step in this direction, the 1997 session of the Wyoming Legislature passed legislation authorizing the Governor to take the state's share of Federal mineral royalties in-kind should Federal law and policy so permit. This was a strong statement by our legislature of their desire to have the state move in this direction.

In followup to this, as a part of the Minerals Management Service's effort to look at possible pilot projects, Wyoming has offered a pilot project to the Minerals Management Service. We are appreciative of their efforts in working with us.

However, I would offer one note of caution. While we believe that there is value in a pilot process in order to test a methodology for a royalty-in-kind program. Due to the inability to aggregate large volumes and reduce administrative costs in a pilot program, we feel it should not be looked upon as a test of the net ability to enhance revenues as a result of royalty-in-kind.

I would like to move on and quickly focus on some of the key elements that the State of Wyoming believes are critical in a Federal royalty-in-kind program in order to allow full participation by the states. The first and most important of these would be that the state would have an absolute right which it could exercise to receive at or near the lease its 50 percent gross share of Federal royalty oil and gas.

We would further encourage that the states be given an opportunity, or a preference I might say, to also acquire and market on the Federal Government's behalf the Federal 50 percent share provided that the net return to the Federal Government would not be reduced thereby.

Because it has clearly been shown that there are advantages to aggregation through the market strength that comes with larger volumes, allowing the state to potentially handle 100 percent of the royalty volume would be a step in the right direction.

We do think it is important in a royalty-in-kind program that the state be entitled to the full 50 percent of its gross share of Federal mineral royalties, and that the state then bear the marketing costs, the state bear the risks associated therewith, but not be put in a position of having to bear the Federal administrative costs, which we would hope would be dramatically reduced as a result of a royalty-in-kind program. I am aware of several additional principles that the industry has developed, and we would be supportive of these.

Finally, let me say that a royalty-in-kind program is not a simple step forward. I believe it does involve a major reengineering of the current approach to royalty receipt. We have had the opportunity to personally view the program in operation in Alberta, Canada. While their situation is very different, we believe that their program as it currently operates would provide a good starting point for the development of a Federal program in the states.

But I would emphasize in closing the importance that we see in the development of a program that this be done as a joint effort involving the Minerals Management Service, the affected states, and the industry on an equal footing basis. What comes out of this would be something that there is a comfort level with that it will work for all of the various interests. Again, I want to take this opportunity to thank you for being able to appear before the committee today.

[Prepared statement of Mr. Magagna may be found at end of hearing.]

Mr. THORNBERRY. Well, thank you and I appreciate all of the testimony of each of you gentlemen. We are going to have to go vote. We have a few minutes of debate and then the vote on the tax bill. I just want to make one comment before we do that. As some of you may know, I introduced a royalty-in-kind bill last Congress. Anybody who suggests that that was an effort by the oil and gas companies was not around because that was certainly not the case. They were less than enthusiastic about that idea.

The motivation is what it can mean for the taxpayers, and those are the ones that I think really have some to benefit, as well as the states. And we have a lot to learn from what is going on in your states, what is going on in Alberta, the input of the industry, and the very valuable input that MMS is gaining in their meetings across the country.

And I want to get that input because my plan in September is to introduce another royalty-in-kind bill because I think it is important to push this idea forward, to have something to talk about, and I want to see this move forward for the taxpayers and for everyone. And so that is the kind of input that we will look forward to. We will recess temporarily as we go vote.

[Recess.]

Mrs. CUBIN. [presiding] Please pardon me for having to be gone. I had a bill that I am the sponsor of being marked up in another committee. And then, as you know, for the first time in 16 years we just voted a tax cut for middle class Americans and all Americans. And we are really happy to have done that. I think I will let Mr. Brady question the panel to begin.

Mr. BRADY. Thank you, Madam Chairman, very much. I appreciate the panel, first, your testimony and, second, the patience you have for us to go vote today. I guess for Mr. Reid, because I am from Texas and pleased with how the system works, as a member of the legislature I have supported some of the changes to make that program more efficient, more effective as you learn how to do it well and better. And we are very pleased with the results.

Two thoughts: one, I am impressed with the efficiency of the Texas R-I-K program versus the current Federal in-value system on the basis of employees. And could you at some time provide to the Subcommittee a table showing the staff-to-volume ratio in Texas for both your oil and your gas programs?

Mr. REID. I would be happy to.

Mr. BRADY. And, second, do you have any suggestions on how the Texas program could be expanded to a Federal program?

Mr. REID. If I understand your question, one of the issues with the Texas program, of course, is so much of the benefits we receive there come from the agency end-use program. Obviously, the Federal Government is a major consumer of gas, and there might be a potential for a similar program at the Federal level.

As far as our experience on our in-kind, our spot sales say of gas or oil sales, the issue in Texas—we do have a situation where we have enough quantities—volumes in enough concentration for it to work. I mean, there may be selected areas where MMS may have the ability to do that.

Our spot sales do not generate the spread that our agency sales do in terms of our enhancement. When you look at our total enhancement, they are probably less than 5 percent of it. But in terms of how it works, I mean, we handle it in-house. We are looking at a private marketing firm to do it.

And in Texas it is really a cost benefit analysis. If we make more money doing it the other way, we will do it. If we don't make more money for the school fund, we won't. And we do a cost benefit analysis periodically on our gas program and on every oil sale to see whether we are really generating more revenue for the school fund than we would have received as a royalty payment.

Mr. BRADY. So it is in the State of Texas program. Rather than using state resources passively to regulate and audit, you use it actively to get the most value for those in-kind products that you receive. Is that correct?

Mr. REID. Right.

Mr. BRADY. Thank you very much for your testimony. I appreciate it. And the representative from Louisiana, a question for you. Do you have an assessment or have you done an assessment of the cost savings of shifting your current audit staff and litigation expenses you have into a marketing type of program? Have you had an opportunity to take a look at that type of change?

Mr. DAROUSE. No, sir, we have not.

Mr. BRADY. Is your program a bit—in your opinion, has it been restrictive in its criteria as you have tried to enter the market and look at the oil side of it or the gas side of it? Do you feel like there are improvements in the Louisiana program that could allow you to make it more effective?

Mr. DAROUSE. Our written comment addressed that. We think that if there are certain changes made legislatively, and if conditions change, that it would be beneficial to market our gas in-kind. Right now there just seems to be a consensus that there are some prohibitions against doing this effectively. I know back in 1985 or 1986 we considered a program similar to where Texas ended up and that would be taking state gas in-kind and sending it to institutions, and it never really got off of the ground.

Mr. BRADY. But that would be an implementation that could assist the cost benefit part of the program for the State of Louisiana and could generate more——

Mr. DAROUSE. Yes, sir. To a certain extent, yes, sir.

Mr. BRADY. Great. Thank you. Thank you, Madam Chairman.

Mrs. CUBIN. I want to welcome you, Mr. Magagna. Everyone knows you are from my great State of Wyoming, and thank you for your testimony. As usual, you always do a yeoman's job for the state, for the Governor, and for me as well. And I want to thank you for that.

While I wasn't here to hear your testimony, I did read everyone's testimony before the hearing so I do have an idea of what all your feelings are. But, Jim, your testimony about R-I-K was quite specific on what you believe will be necessary for a success.

And one of the things that you stated in your testimony was the states must have the right to receive 50 percent of the gross share in-kind. Does that mean that it would be entirely unacceptable to Wyoming to adopt to a R-I-K program like they have in Alberta where private marketers would sell all of the mineral?

Mr. MAGAGNA. Madam Chairman, no, not at all. In fact, we believe that the appropriate way for a program to operate would be for the state to contract with private marketers to market the state's royalty share. All I mean to say by that is that we should receive 50 percent of the gross without any obligation to any deduction therefrom back to the Federal Government.

Mrs. CUBIN. I am not sure and so I hope someone will correct me if I am wrong about this, but I think that in Alberta they market all of the mineral so that I think the way it would be is that a marketer would sell the Federal share and the state share together and then divide the money. Is that right?

Mr. MAGAGNA. All of it.

Mrs. CUBIN. Right, right. But, anyway, that would be the method, and is that an acceptable arrangement do you think for the State of Wyoming?

Mr. MAGAGNA. That the marketer would share——

Mrs. CUBIN. Would sell the Federal share and state share and then the money be divided after the sale.

Mr. MAGAGNA. That would be dependent on who negotiates that marketing contract. It is our belief that the state should be given the opportunity at least as to the state's 50 percent gross of the royalty mineral to arrange for that marketing; in other words, to determine what the terms and conditions would be, to accept those risks associated with the marketplace, even though we would market through a third party marketer.

We would not be comfortable with a situation that simply allowed the Federal Government to market 100 percent of the royalty share as they saw fit with the state simply being the recipient of a check for half of that amount.

Mrs. CUBIN. So then would it be acceptable for Wyoming to be the marketer for all of the mineral and then divide the money and then give the Federal Government their share?

Mr. MAGAGNA. We would certainly find that acceptable, and we would anticipate if that were done and would be willing to accept that there would have to be some criteria in order to assure that the state, in fact, would not be getting less for the mineral than what the Federal Government might be capable of getting. With those parameters, certainly.

Mrs. CUBIN. I agree with you and your statement that de minimus-producing wells could really present a problem with R-I-K. However, as the provisions of the Royalty Fairness Act became implemented which would allow once a year royalty payments or a buyout of royalty obligations by lessors once a year with de minimus production, perhaps there would be room to consider how to take R-I-K for stripper wells. Do you have any thoughts on the cutoff production level for de minimus?

Mr. MAGAGNA. I really would not be prepared today to recommend a particular cutoff level. But when you combine the provisions in the Royalty Fairness Act authorizing the annual payment or the buyout with a royalty-in-kind program, we would be hopeful as you put those together you would be able to thereby eliminate the need for a continuation of a valuation based royalty system because that could be picked up through the specific provisions of the Fairness Act.

Mrs. CUBIN. My time is up and because we have already been interrupted with the vote and whatnot, with your permission, I would like to submit some written questions to you, and then we can move on to the next panel. Thank you very much for your testimony. And would the second panel please come forward? Thank you very much.

I would like to introduce the second panel that is with us today; Mr. Larry Nichols, who is the President of Devon Energy; Fred Hagemeyer, the Coordinating Manager, Royalty Affairs for Marathon Oil Company; Sue Ann Hamm, Vice President of Oil Marketing and Sales for Continental Resources; and Edmund Segner, III, Executive Vice President and Chief of Staff for Enron.

I would like to remind the witnesses that under our Committee rules that the testimony must be limited to 5 minutes, and certainly your entire testimony will appear in the record. So the Chair now recognizes Mr. Nichols for his testimony.

STATEMENT OF LARRY NICHOLS, PRESIDENT, DEVON ENERGY

Mr. NICHOLS. Well, thank you, Madam Chairman. I am Larry Nichols, President and CEO of Devon Energy Corporation, an independent producer who has Federal onshore production. I am here today on behalf of Devon and 13 oil and gas associations who represent most of the payers of Federal oil and gas royalty payments.

For the purpose of the hearing today, I will summarize my comments but ask that the entire written statement be included in the record, as well as this statement which reflects all of the trade associations who are endorsing my statement today.

Madam Chairman, we always appreciate the opportunity to work with you in pursuit of a more simple, a more certain, and a more efficient program for collecting royalties due to the Treasury and the states from Federal oil and gas production.

As each year passes, the need to reengineer the royalty collection system dramatically increases. With each new valuation rulemaking effort, more and more complexity and more uncertainly is added to the royalty collection system. Instead of accepting a producer's wellhead values, elaborate netback schemes are now being developed that will only result in more and more disputes.

All of the agencies' concerns and perceived problems over how to value royalty can be addressed by a royalty-in-kind program. As a consultant, who is regularly used by the MMS, stated in a report to the states, "The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in-kind for sale." We agree that royalty-in-kind accurately measures value by capturing all the value resulting from a transaction between a willing buyer and a willing seller at or near the lease.

There has been much theorizing about the benefits and drawbacks of royalty-in-kind. It is time to bring royalty-in-kind to the drawing table, to build a successful royalty-in-kind program, and once and for all to bring to an end years and years of disputes and debate about royalty payments.

This hearing today brings royalty-in-kind into focus as an exciting reengineering opportunity for both the government and the industry. I would like to tell this committee what the industry is doing to bring royalty-in-kind into reality. First, industry participated in a series of workshops that the MMS held this year in response to their fiscal year 1997 appropriations which asked them to pursue additional royalty-in-kind pilot programs.

At these workshops, the MMS heard a consistent message from the oil and gas industry—yes, we are without a doubt interested in designing a royalty-in-kind program which would result in a more simple and certain royalty collection system.

During these workshops, the industry agreed to outline for the MMS and the states the goals, principles, and design elements of a successful royalty-in-kind program. To initiate this progress, representatives from oil and gas associations from across the country formed a royalty-in-kind workgroup. I am glad to report to the committee that this workgroup has developed an in-kind mission statement and a common set of principles for designing a successful royalty-in-kind program.

The mission statement and principles I am about to describe are supported by the Independent Petroleum Association of America, the Domestic Petroleum Council, the California Independent Petroleum Association, Colorado Oil and Gas Association, Independent Petroleum Association of Mountain States, Independent Petroleum Association of New Mexico, Louisiana Independent Association, Mid-Continent Oil and Gas Association, National Oil Industries Association, New Mexico Oil and Gas Association, Oklahoma Independent Petroleum Association, Petroleum Association of Wyoming, and the Rocky Mountain Oil and Gas Association.

This is a work in progress for all of us. Many critical implementing details need to be developed and discussed among these groups before moving beyond support for these principles. The agreed-to mission statement for a royalty-in-kind effort is to design a royalty-in-kind program that will eliminate valuation uncertainty and will be attractive to the Federal Government, the state governments, and the private sector stakeholders, while recognizing the differences between oil and gas production.

The six agreed-to royalty-in-kind principles are as follows: one, reduce the administrative and compliance burdens while providing the opportunity for Federal and state governments to maximize their revenues. This principle is intended to make sure that a royalty-in-kind program does not move forward unless it is a win-win for the Federal Government, state governments, and the producers.

Two, require transactions to be at or near the lease as required by the lease obligations. Three, provide that when the government takes in-kind it must take all royalty production for a time certain. Four, require use of private marketing expertise to streamline government operations.

We have heard some comments earlier today that expressed concern, with which we agree, that this plan might require the government to get into the business. That is not the case at all. Just as the Federal Government can build buildings without becoming a building contractor and just as the Federal Government can construct highways without becoming a highway constructor and getting into that business, so can the Federal Government market their oil and gas business without getting into that business.

Five, provide the states with the opportunity to be involved in designing and implementing the program. And, finally, six, to make sure that royalty-in-kind programs are broadly available for public purpose. As I just stated, there are a number of design issues that need to be worked out to determine the success of the royalty-in-kind program. We believe that issues such as transportation, aggregation processing, and other matters need to be resolved and look forward to working on that in the future.

This is the time when we need to make certain that we can work together as a cooperative effort. We are concerned with the manner in which the MMS has qualified revenue losses in its gas in-kind experiment. We think those mislead people into believing that a successful in-kind program cannot be implemented.

And, second, and most importantly, we want to make sure—is the concern that a royalty-in-kind program be revenue neutral. Let us not forget that the real value of a royalty-in-kind program is to save the tremendous administrative costs that are currently being incurred by the Federal Government, the states, and the industries.

Before the MMS moves forward with a royalty-in-kind program, we need to make sure that a royalty-in-kind program can adhere to the six principles that I discussed above. Thank you very much, Madam Chairman.

[Statement of Mr. Nichols may be found at end of hearing.]

[List may be found at end of hearing.]

Mrs. CUBIN. Thank you, Mr. Nichols. Mr. Hagemeyer, would you please give——

STATEMENT OF FRED HAGEMEYER, COORDINATING MANAGER, ROYALTY AFFAIRS, MARATHON OIL COMPANY

Mr. HAGEMEYER. Sure. I would be happy to. Thank you, Madam Chairman, members of the committee. I am Fred Hagemeyer and I am pleased to be here this afternoon representing Marathon Oil Company. There are several oil and gas associations that have endorsed my written comments, and I would like to introduce those into the record if I may.

Marathon is a fully integrated oil and gas company involved in worldwide exploration, production, transportation, and marketing of crude oil and natural gas. Marathon holds leases both onshore and offshore. In 1996, Marathon paid royalties of over $84 million for oil and natural gas produced from Federal and Indian lands. In addition to the royalty paid in cash, the Minerals Management Service took crude oil valued at over $9 million in-kind through the small refiner royalty-in-kind program.

We are here today to discuss royalty-in-kind as an alternative method for satisfying the royalty obligations of producers with Federal oil and gas leases. Public workshops were held this spring to discuss and review possible options for a major royalty-in-kind program. Marathon actively participated in these sessions and welcomed the opportunity to candidly discuss critical features of a workable R-I-K program.

At Marathon, we have learned that reengineering an entrenched process is not easy. But if all stakeholders are engaged in the process and it is done properly, the results can be significant. Many times the benefits are much greater than anticipated because it is difficult to identify all the indirect benefits. As part of the MMS reengineering effort, Marathon believes that a R-I-K program can be created which will fundamentally add value to the MMS royalty process.

Royalty-in-kind is a concept whose time has come. The key is turning this opportunity into reality. By taking its royalty oil or gas in-kind, the MMS has the opportunity to aggregate volumes, determine the most favorable sales locations, arrange transportation, and negotiate the terms and conditions of the sale of its royalty production.

Participation in these activities can result in optimized value if the MMS manages the risks and costs associated with the marketing function. Expertise of a competitive private marketer would allow the MMS to participate in these activities in the most efficient manner possible and thus achieve the greatest possible revenue benefits. The administrative burdens of both the MMS and the Federal lessees, especially the audit and litigation costs, would be reduced significantly or even eliminated.

As Larry Nichols mentioned, a multi-association task force has been recently formed to develop a workable Federal royalty-in-kind program. Marathon is an active participant in this task force. Marathon would welcome and does welcome the certainty of knowing its royalty obligation was fulfilled once the royalty barrels were delivered to the MMS.

And Marathon recognizes that expertise in all segments of the oil and gas business will be necessary to develop a Federal royalty-in-kind program that is both viable and workable. It seems that the Subcommittee can benefit tremendously from the efforts of this task force. This process is not easy, but we feel it is vitally important in developing a successful program.

An important step in this process is to look at examples of existing R-I-K programs—the Texas GLO program, which you heard about earlier, takes all of its royalty all in-kind from the Marathon-operated Yates field, one of the largest onshore oil fields in the United States. Overall, Marathon's experience with the Texas royalty-in-kind programs has been positive.

One of the lessons that we have learned from the Texas R-I-K program is that any new comprehensive program is going to experience startup problems. During the first year of the Texas programs, there were problems concerning which party was responsible for gathering costs, the arrangement and verification of transportation, and the proper allocation of production.

However, over time, producers, the purchasers, and the state have been able to work through these problems. And for this reason the MMS must be very careful if it chooses to implement and evaluate any royalty-in-kind pilot program. In fact, Marathon believes it may be more prudent to expend this effort in developing a permanent R-I-K program that could be phased in over time.

Marathon is concerned at the impact of a royalty-in-kind program on the Federal and state treasuries, that it be analyzed properly. API recently completed an assessment of the MMS review of the 1995 Royalty Gas Marketing Pilot Program. Attached to my testimony is the API report which raises a number of issues for the underlying validity of the revenue assumptions and the cost analysis of the pilot. The concerns raised by API should be addressed.

In summary, I would like to say that Marathon believes the time has come for the Federal Government and the oil and gas industry to seriously consider royalty-in-kind as the best long-term solution to satisfying the Federal lessees' royalty obligation. A properly developed R-I-K program could streamline the royalty process for the Federal and the state governments and the oil and gas industry.

Working together, we can minimize many of the startup problems which may occur and shorten the learning curve for both the Federal Government and the lessees. A royalty-in-kind program can be a win-win proposition for all the parties involved. Thank you very much.

[Prepared statement of Mr. Hagemeyer may be found at end of hearing.]

[List may be found at end of hearing.]

Mrs. CUBIN. Thank you very much. The vote that is being held now is a vote to adjourn, and I think I will just let them decide that without me so that we can get this hearing moving along. Ms. Hamm, would you please give us your testimony now?

STATEMENT OF SUE ANN HAMM, VICE PRESIDENT, OIL MARKETING/SALES, CONTINENTAL RESOURCES, INCORPORATED

Ms. HAMM. Thank you, Madam Chairman. I am Sue Hamm, and I am Vice President of Crude Oil Marketing for Continental Resources. And I am here on behalf of Continental, IPAA, OIPA, and the RMOGA, Rocky Mountain Oil and Gas Association, and they are all endorsing my written——

Mrs. CUBIN. Excuse me. Could I get you to pull the microphone a little closer?

Ms. HAMM. Oh, I am sorry.

Mrs. CUBIN. Thank you.

Ms. HAMM. And I would like to submit that for the record. And Continental Resources is a small, privately held independent producer who has Federal onshore production. And I am not going to go into everything I have written to brag a little bit about Continental, but we are a growing company, and I am very proud of them.

Two years ago, I began the crude oil marketing department for Continental. And I did this after looking at our wellhead contracts. Traditionally, we sold at the wellhead. And with change in transportation and unbundling and opportunities to transport on pipelines, I saw that there were opportunities.

And so I looked at—checked out all of the alternatives and opportunities, and I found that our company is able to realize a higher average price per barrel by taking our oil to the end-user to make all the transportation arrangements, exchanges, and final sales. And we have even built our own gathering systems where that proved economical for us to lower our transportation costs.

We tried to create as many alternatives as possible. The more buyers there are, the higher the price is we find. And we have encountered a great deal more risk and costs than we had anticipated, but we have been able to work these out just by working through them and with the advice. We looked to other industry experts. In fact, we even hired a consultant for a year and paid him five cents a barrel to guide us through this.

And even at the five cents a barrel charge, we found a significant increase over our net revenue from the wellhead price. And we continued to sell some at the wellhead so we did know what that wellhead price was, and we continued to negotiate very toughly for a wellhead price. But even still we had a significant increase by taking on the responsibilities to market downstream.

And as we became more sophisticated in our marketing efforts, we began to take our oil and gas from outside interests. And this is a little bit like the MMS would be encountering because they are not operating the wells in which they have their interests, and they are not getting all the information as timely as an operator does.

But we have still found that in most instances we can improve our price by taking an in-kind and taking it downstream. And to determine whether it is economical, again, we look to a number of factors—transportation costs, prices downstream, prices the purchasers will offer at the wellhead, and the price that the operator is receiving because we can't continue to sell through the operator.

But one factor we do not even consider is what price is the operator receiving through his contract. We just look at what he is paying us. We do not consider audits a value-enhancing measure or it is not our job. And after we consider all the factors, we choose the method which we will receive the highest price. As I said before, this continues to be marketing downstream for the most part except for de minimus volumes.

And we have a fairly significant volume for a small company. In fact, it is about 7 percent of MMS's royalty volume. We have 15,000 barrels of oil a day, and we produce 75,000 Mcf of gas a day. And this is 3 percent of MMS's royalty gas. And this is a large amount as far as the MMS's volume, I believe, that we are able to handle with two employees. And of our volumes, we have 200 equivalent barrels which are Federal royalty barrels. And this is a negligible amount for us.

But this is a small amount when you consider MMS's royalty volume where I have heard that they say aggregating volume does not enhance the value. Well, it sure did for us even with our small amount. The more oil we produce and we include in our package, the higher our prices become. The refiners are seeking us out. They want to go directly to the producers to ensure their oil. Oil is still a valuable product.

And the present situation between the MMS and the oil and gas industry has become one of the most adversarial relationships of any agency. And even though we have a negligible amount of Federal royalty barrels, it looks like we don't have a dog in this fight, I have heard you say.

But we are taking a broader view as you have recommended, and we are going to stay involved in this issue because we are in the oil and gas industry to stay. And anything that affects us—that affects the industry affects us. And we believe that the proposed rules will negatively affect the industry, and, in fact, we oppose them. And I really wanted to get into the Canadian effort, but I——

Mrs. CUBIN. Go ahead.

Ms. HAMM. I went to Canada and met with Don Olineck, the Director of the Alberta Energy, and went through quite a few of his programs, and he was very accommodating. He showed me all of his flow charts. He showed me all of his forms. And I discussed this thoroughly with him, and he believes that this could be transferred to the MMS's properties.

And he has offered all of his help in setting up the program, setting up the computer programs, advising. He will do anything he can to help us transfer his program to our situation, and he believes it will help. Alberta Energy believes that they are increasing their value by taking in-kind and selling it downstream.

And the goals for their R-I-K I believe meet MMS's goals. They are simple and certain; simple in the fact that a minimum number of employees are required to run the program. Alberta Energy for their 146,000 barrels of oil a day have 33 employees marketing the oil. MMS has 204,000 barrels of oil a day—a little bit more than Alberta—and they have 1,800 employees a day. Gas production is roughly equivalent between the two companies. Alberta only has 232 total employees for all.

What is the reason? It is not the MMS employees that are not competent. They are very competent people. They are high standards, high quality. It is the system they are having to work with. That is why it takes so many. This audit—receive an audit is not a workable situation.

And to follow the Alberta program, the MMS would have to take its production at the wellhead, and the operator would deliver to the MMS's designated representative the royalty volume. And the operator would continue to deliver to his own purchaser his volume.

The only difference from the operator's current methods would be to carve out the royalty share of volume, as opposed to the royalty share of value. And by carving out just the royalty share of volume, this would dramatically reduce the number of reporting requirements for the operator and for the MMS. Thus, the decrease in number of employees.

And just to look at our situation, two employees for 15,000 barrels of oil a day; 1,800 employees for 204,000 barrels of oil a day. Something is happening there. My husband and I own the company. I have a vital interest in increasing our revenue. I do not have a stake in keeping a job in crude oil marketing. R-I-K works. I recommend it for the MMS. I will help any way I can. There are industry experts out here. We are all good at this.

The MMS can be good at this. They have to get in the program. They have to get in the market. Just watching it doesn't help. You have to get in it and negotiate. And by hiring a representative and with transparent contracts, the MMS will know and be assured they are receiving market value. Thank you.

[Statement of Ms. Hamm may be found at end of hearing.]

[List may be found at end of hearing.]

[Petroleum Marketing Act may be found at end of hearing.]

Mrs. CUBIN. Thank you very much. Mr. Segner.

STATEMENT OF EDMUND SEGNER, III, EXECUTIVE VICE PRESIDENT AND CHIEF OF STAFF, ENRON CORPORATION

Mr. SEGNER. I am Ed Segner, Executive Vice President of Enron, a diversified energy company headquartered in Houston. As a major participant in the upstream, midstream, and downstream domestic energy markets, Enron obviously has a direct interest in the proposed R-I-K program, both as a marketer, in which we are one of the very largest in the country, and as a producer.

Recent changes in the natural gas industry, including the deregulation of wellhead prices and the demise of pipelines as the primary purchasers of natural gas, directly affect the current debate over royalty valuation. These changes have led to a number of controversies between industry and government. The Department of

Interior has been questioning the principle that royalties are to be determined at or near the lease, as has been the historical practice now for about 70 years.

Rather, the Department is apparently considering that royalty values be determined far downstream of the lease after the value has been enhanced by a variety of services performed in the midstream and downstream markets. This position, of course, fails to recognize that participants in those markets make significant capital expenditures and undertake a variety of risks not associated with the risks that are undertaken by oil and gas lessees.

Such a position, obviously, is fundamentally at odds with the way in which natural gas is marketed today. Natural gas producers no longer dedicate the production from specific properties to specific sales contracts. Most production today is sold under contracts that specify no source of supply but rather require that specified volumes be delivered to designated delivery points.

Producers can and do supply gas to such delivery points from various sources of supply, including their own production, or in the event of a shortfall in order to meet a firm delivery commitment, by purchases from other producers or marketers. Even when a producer's own production is used, it may come from a number of properties upstream from the point of delivery.

Similarly, midstream producers do not supply their downstream customers with gas obtained under specific purchases from identifiable producers. Rather, production is aggregated at pooling points where it is bought and sold or transported to all other points all in the marketer's efforts to maximize its profits by seeking the best market available.

Gas has become like grain or pork bellies, a fungible commodity. Attempting to value gas on the basis of downstream transaction would be like determining the value of a particular farmer's corn crop, by looking at the prices in the grocery store.

We believe that a properly designed royalty-in-kind program can both resolve many of the current controversies arising out of these changes, while providing many advantages to the government resulting in a win-win situation.

In a well-designed royalty-in-kind program, the Federal Government would use the expertise of sophisticated marketers to access markets nationally and provide timely and accurate information. Using the services of marketers, the government could realize increased revenues through, one, aggregation of its substantial volumes; two, the administrative savings of simplified auditing; and, three, the absence of disputes.

Our Enron Oil Canada unit produces oil that is subject to Alberta's royalty-in-kind program. Our experience under that program has also been extremely positive. Valuation disputes under the program are virtually nonexistent.

Further, the program is simple to administer from both a logistical and accounting standpoint. A single accountant in our company spends less than 4 hours a month filing the required reports. In addition, the province bears its proportionate share of downstream costs like any other interest owner, thus providing equitable treatment to the lessees.

In April 1995, after an exhaustive joint government and industry study, the Minister of Energy advised that a cash based royalty system such as that as used in the U.S. could not be implemented because it would result in a financial loss to the province and create an administrative burden for both industry and government.

In addition, we have also recently begun to participate in the Texas program. We also are very satisfied with that program. It has been a positive experience. And, in fact, with respect to our operations, it operates so unobtrusively that I think that speaks volumes for the quality of the program.

It is for these reasons that a royalty-in-kind program is so important. Competitive bidding for the government's share of production would simply and fairly establish its value, while providing the best means available to ensure that the government receives full value for oil and gas production from Federal lands.

It offers the government the ability to realize the maximum value for its share of production, while at the same time streamlining its own operations. We thank you very much for the opportunity to appear before this Subcommittee today, and at the same time, we assure you that we offer our assistance in developing a successful program any way we can.

[Prepared statement of Mr. Segner may be found at end of hearing.]

Mrs. CUBIN. Thank you very much. Mr. Thornberry, would you like to begin questioning?

Mr. THORNBERRY. Thank you, Madam Chairman. I guess my number 1 question that I would like to address to each of you, because some of you represent a number of companies and organizations, is do you think the industry is serious about getting this done? Do you think a consensus can be built? And what is the primary obstacle to getting it done?

As I mentioned a few minutes ago, I have been down this road before. And while some in industry said they thought it was a good idea, it didn't go very far. But I would like to get you alls' view on whether it can be done, whether we can reach a consensus. Mr. Nichols, do you want to start?

Mr. NICHOLS. Yes. I definitely think we can reach a consensus, and I would like to put this in some historical perspective. Earlier in the hearing today, we heard that because last year we had passed the Royalty Fairness Act, with the able leadership of this Committee, that now was an inappropriate time to go back in and reevaluate or do anything different.

The Royalty Fairness Act dealt with procedures. There is nothing in the Royalty Fairness Act that dealt with valuation. Both this Committee and the industry and the MMS recognize that those valuation issues were out in front of us and were not touched at all by the Royalty Fairness Act.

When we saw earlier this year the MMS proposal on oil valuation, which was based upon NYMEX, or despite some earlier statements I heard today, NYMEX is not where the oil and gas industry trades amongst itself. We trade oil at the lease or near that, not at NYMEX. That is totally false.

Our company sells a lot of oil, and it is not based on NYMEX prices. That is not what we have any hope of realizing. Sometimes it is up, sometimes it is down, but that is not where we trade. That is where they trade in New York City. It is not where we trade in Wyoming or the Texas panhandle or wherever.

When that was proposed with a complicated system to get it back to where we really do trade, and the MMS recognized that NYMEX was not where it was traded and was only using that as a starting place, we had used a fairly complicated and somewhat arbitrary within their own control system to get it back to the lease or attempt to get it back to the lease, many people in the industry looked at that and said, "Good grief. There has got to be an easier way."

Mr. THORNBERRY. So you think there is renewed focus on solving the problem?

Mr. NICHOLS. The oil valuation program gave tremendous focus and tremendous impetus within the industry to please find a simpler way, and R-I-K particularly became the simpler way.

Mr. THORNBERRY. What do you think is the biggest obstacle?

Mr. NICHOLS. The inertia, that change is always difficult, working out problems. In my testimony earlier, I listed the six principles that 14 trade associations have already in a relatively short period of time gone together and agreed upon. We need to work on the details of those, broaden the industry group to include everyone, but I believe that can be done.

Mr. THORNBERRY. Thank you, sir. Mr. Hagemeyer?

Mr. HAGEMEYER. Yes. I also would agree that the industry has pulled together to focus on this particular issue for a variety of reasons, and we would be remiss in suggesting that it wasn't because valuation perhaps was a catalyst. In the past, you would have maybe certain components in an integrated oil and gas company who would look at valuation regulations. And what you have with royalty-in-kind is probably a bigger picture.

So it encompasses all aspects of the oil company, and this takes time for the oil companies to focus on this, and this is something through this association task force that I think has just recently started happening. If there was royalty-in-kind discussions in past timeframes, it never had this kind of discussion, which is all encompassing, and a realization that you just don't do it with little bits and pieces and parts. And if you are going to put something forward, it has got to be somewhat comprehensive.

And so it really has energized, in my opinion, a lot of companies to really talk through the issues. And as Larry pointed out, there were six principles developed in a matter of a few weeks by this task force which kind of set a stage, and there was a lot of structural elements under that that have to be sorted out and talked through. You know, there is a lot of very important issues that have been mentioned before in terms of voluntary, mandatory, the transportation issues, turning over title at what point, and how can that be clean.

But the key is that it is kind of a reengineering focus. I mean, the purpose of this group right now has really been trying to look at it from a clean piece of paper, not being incumbered by other things, and saying if you had a very, very good royalty-in-kind program that tried to satisfy all aspects, how would it work? And I really feel confident that over the next few weeks or months that that can come about.

Mr. THORNBERRY. OK. Thank you. Ms. Hamm and Mr. Segner, I would like to get at least you alls' opinion on what the biggest obstacle is.

Mrs. CUBIN. And don't worry about the light. You can have as much time as you want, Mac.

Ms. HAMM. The transportation issue and the mandatory versus voluntary appear to be the biggest obstacles that I have seen. And I believe they are workable, especially—we need from MMS what are their problems with transportation. What kind of comfort zone do they need in order to work in the marketplace on transportation? If we knew what their fears were, then we could arrange the principles and issues and help with the rule. And then the mandatory versus voluntary we are going to, of course, have a consensus on that, and I believe in mandatory.

Mr. THORNBERRY. OK. Thank you. Mr. Segner?

Mr. SEGNER. I think the biggest issues are going to be in the marketing side from the standpoint of dealing with the de minimus volumes, finding mechanisms to make sure that a large enough percentage of volumes is, in fact, being served under this program. Obviously, 100 percent would be best in our view because we don't want to see a situation where you end up with a lot of administrative costs left over. So we want to be sure that we get the whole thing.

I would say from the marketing standpoint I think clearly there is huge competition now in marketing, as we all know, and I think that having a producer—in essence, the Federal Government, be as large as it is—that is a sizable volume, its portfolio well spread out. I think it will be very well-received by the marketing community, and I think it will be very competitively bid and structured.

Mr. THORNBERRY. Gives us lots of buying power when you have that much oil to sell?

Mr. SEGNER. Yes.

Mr. THORNBERRY. Let me ask each of you, have any of you had experience with the MMS pilot program on gas?

Mr. NICHOLS. We participated in a very minor way in the pilot program offshore.

Mr. THORNBERRY. OK. Do you have comments about that program, ways that it can be improved, why we should or should not learn particular lessons from it based on your experience? And if you don't have enough, that is fine. I just wondered.

Mr. NICHOLS. Yes. Our experience with it was extremely small as an independent. I know there are a variety of design flaws in the way it was implemented, that both we and the MMS learned from that that could be corrected in a royalty-in-kind program. We see nothing in the comments that I have read about that cannot be easily corrected.

Mr. THORNBERRY. OK. Madam Chairman, one other thing. Mr. Nichols, since your company was specific mentioned in some earlier testimony, I thought you might want to have the opportunity to respond to the concern that some people have that someway a royalty-in-kind will prevent or you will lose arm's length transactions, and there will be some sort of sweetheart deal and this, and the taxpayers are going to get the short end of the stick. If you would like to respond, I certainly want to give you a chance to since your company was specifically mentioned.

Mr. NICHOLS. Well, I must admit I was somewhat amused and perhaps flattered to think that our company would be large enough to successfully market Federal royalty oil. Earlier this year, we were marketing a grand total of about 300 barrels a day, and that feeble effort proved to be so small that we abandoned it on April 1. So I don't think we have the capacity to be a marketer. That is not what we are. We are a pure independent producer.

There is no doubt in our mind that a successful program could be implemented. The reason the industry is in favor of a royalty-in-kind program is to reduce cost. The government is entitled to the royalty oil that it gets. There is no one who argues that point—and the royalty gas. You can take that and aggregate that together and have a win-win situation where the government, because it can aggregate that oil and gas, can realize more revenue.

I know from my own company's experience, we did an acquisition at the end of last year that gave us more oil to market because we own more oil in west Texas and southeastern Oklahoma. Just because of that small aggregation relative to us, we are able to realize a higher price for that oil.

The Federal Government could realize an even higher price because they have much, much larger volumes than we do. So you have the ability to realize more revenue on one side, and the ability to save costs, both for the industry and the MMS, on the other side. It looks like a win-win.

Mr. THORNBERRY. Thank you. Madam Chairman, I appreciate your indulgence. Because of the lateness of the hour, I won't continue. I do have some questions I would like to submit for the record, and hopefully these witnesses could provide us some additional insights if that is all right.

Mrs. CUBIN. And we also would ask unanimous consent for the Minority to enter any questions in writing that they would like. Mr. Dooley?

Mr. DOOLEY. Thank you, Madam Chairman, and I apologize for having a conflict and not being able to hear the entire panel. I guess my interest here is in terms if you did go to the royalty-in-kind process, should it be structured in a way that perhaps we just let the states administer it. I mean, we have Texas who already has their program in place. You know, why should the Federal Government be involved? Why don't we just let the State of Texas do it? Anyone that wanted—I guess, Mr. Hagemeyer, you——

Mr. HAGEMEYER. I will maybe just try to address that a little. I guess you are asking a question that probably we haven't ourselves even had time to get into and discuss, and I think that is one of the issues on the task force list to talk through; not that we have necessarily the solution, but maybe we can talk through the pros and cons.

You know, I think one thing that fundamentally we would see is that, you know, the Federal Government would have the right of the oil, the title to it when turning it over at the lease. And I guess the key there would be what would be the most efficient way?

That is what we all would want to see. So if the states could do it more efficiently than the Federal Government through a private agency, then that is something to consider. I guess the options are still open in reviewing that, and it is something that probably when you talk it through, many of the states (Texas has quite a bit of an experience, and Wyoming is now looking at it in various stages), have a different scope of experience level.

So if you were to move into some program, you may only have a few states who have enough experience to do very much. But I guess the jury is still out.

Mr. DOOLEY. Well, that is kind of the way that I am looking at this is that, you know, we have some states that are at different levels of I guess competency just by experience by and large. But I guess I question, you know, it might be something that it might be best administered on state by state and basically be a state choice, whether or not to go down that path of royalty-in-kind.

If you went down that track though, you know, I question whether or not we ought to have MMS in a position where they are required to put together the administrative infrastructure to administer a payment-in-kind program in one state that might have the capability to do it themselves.

And maybe we would be better off letting them do that, and those states that didn't choose to go into royalty-in-kind that we would maintain something, maybe even what is proposed hopefully with some modifications.

Ms. HAMM. The industry workgroup has agreed that it would like for the states to have the option to take their royalty-in-kind so I think that answers your question to a degree. States which show an interest we want to allow it to have the right to take their oil in-kind.

Mr. DOOLEY. And that would just be the state's share of the royalty-in-kind?

Ms. HAMM. That is as far as we have gotten. We haven't addressed taking the Federal royalty. We would like for the states to have the option to take the Federal royalty too, to have the right to bid for it. And we haven't written that down as a principle agreed upon that has been discussed to let the states take the Federal royalty. But the only thing which has been agreed upon is the states to take their own share.

Mr. DOOLEY. I had a chance to read some of your testimony, and you visited Alberta and viewed theirs. How did they deal with—and I think Mr. Segner made the comment, you know, the very, very de minimus producer in some instances—you get to some level that is not cost effective, you know, to put I guess in place an in-kind type of program. Does Alberta have similar problems, and how are they addressing that?

Ms. HAMM. My understanding is that they don't take that which they are not able to administratively costwise justify, and there are some instances where they take the operator's volume totally also and market it for them because the operator believes that Alberta Energy has more expertise than they do.

But I believe they have been at it so long that this was not all thrown at them at one time. This has been as a well develops, as wells are drilled, they have gotten to make the selection. And then once they do have it in place, as wells decline, then it is easier to keep the R-I-K in place. Where for us, we will have to make the election with wells which are already declined whether to take it in-kind of not, so it would be a little bit different deciding right off to take everything.

Mr. DOOLEY. Does anyone else have a comment on any of those questions? All right. Thank you.

Mrs. CUBIN. I want to ask you, Mr. Nichols and Mr. Hagemeyer, anyone who wants to answer, a little bit more about the multi-association task force. That is the same industry working group that you were referring to, Ms. Hamm? It is all the same group? OK. And, Mr. Nichols, you are here representing those groups that are in working on the task force. Is that correct?

Mr. NICHOLS. Yes.

Mrs. CUBIN. And that is mostly independents. Is that correct?

Mr. NICHOLS. Yes, of all sizes. There are very large independents and very small independents, but they are all included in that group.

Mrs. CUBIN. I am not going to ask a lot of questions now, but, again, if you would indulge us and allow us to send some written questions to you, I would appreciate that. But I do want to say one thing. I know Mr. Thornberry is anxious to get this moving and anxious to have a bill, and I support him in that.

And we would appreciate it, if you don't mind my speaking on your behalf, if the MMS and the states and your task force and the majors could come together with some suggestions because I think we will have better legislation if everyone can work on that than if we just draft something just to get the issue moving. That is what we would like and what we would appreciate is just some movement on this.

So I don't really have any other questions. I will just leave you with that request, that you work together as much as you can in a timely fashion so it makes it a little easier for Mac and for me. Mr. Nichols?

Mr. NICHOLS. Yes. Madam Chairman, if I might add, included in that group and included in those associations are major integrated companies, that there really is no schism in the industry based on size or character in facing this issue.

There are individual companies and individuals that are still studying and are not yet committed to it. But I think that consensus is rapidly forming, and it will be one that is from the largest integrated down to the smallest mom and pop. You know, we all share the common desire of a more simple and a more certain royalty collection system.

Mrs. CUBIN. And I do encourage you to work with the states as we go along that I know we can have a better bill by doing it that way. Thank you all very much for your testimony today. Ms. Quarterman, I certainly appreciate your sitting through all of these hours of testimony and voting and whatnot. I know it has been a long day for you, and we do appreciate your hanging in there with us. So if you would kindly give us your wisdom, we would be happy to hear it.

STATEMENT OF CYNTHIA QUARTERMAN, DIRECTOR, MINERALS MANAGEMENT SERVICE

Ms. QUARTERMAN. My pleasure. Madam Chairman and members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on behalf of the Minerals Management Service in our ongoing examination of the feasibility of taking oil and gas royalties in-kind.

I would like to say that we are very excited about the notion of taking R-I-K. We have been studying this issue and considering opportunities that in-kind royalties may offer the government, industry, and, most importantly, the American taxpayer.

Over the past several years, MMS has spent a considerable amount of time studying the opportunity to take royalty-in-kind. It has been a major learning process for us. We have, as you know, conducted an analyzed R-I-K pilot that was implemented during 1995. We have convened six public workshops around the country relating to R-I-K.

We have surveyed energy marketers that we would not ordinarily have an opportunity to work with. And we have interviewed other government agencies who have experience in R-I-K, including our international sister nations going over to Alberta, Canada, and speaking with them as well.

In short, I believe that we have developed a significant body of knowledge and expertise concerning the potential for applying in-kind programs to Federal leases. I ask that my prepared testimony be admitted to the record, and I will summarize for you here what is in that testimony.

By way of background, the energy industry has changed dramatically over the past 10 years. As some of the folks who have been here today have already testified, the once dominant wellhead sale has been replaced by more frequent downstream sales by affiliated energy marketers and is particularly true in the natural gas market.

A series of downstream activities frequently occur before a first sale is ever made. For natural gas, first sales may not occur until the burner tip in a residential consumer's home. Increased downstream activity has complicated royalty valuation to a large extent which has fostered disputes between the Minerals Management Service and the producers.

Administrative appeals and litigation have proliferated as a result. And the energy industry and MMS have struggled over the past several years to resolve these many issues. Along with clearer valuation regulations, R-I-K programs may offer a solution to avoid such disputes.

In what we see as a best case royalty-in-kind scenario, a number of things we think would be possible. First, we think that valuation disputes could be eliminated or at least reduced, that auditing could be reduced to a simple volume reconciliation that would be completed quite quickly, that there would be less need for royalty reporting and verification, which would accrue to administrative savings on behalf of both the government and industry.

We also believe that there is a potential to enhance Federal revenues by aggregating volumes and marketing. The extent of such benefits requires examination and analysis, and that is what we are currently in the process of doing.

As this Subcommittee will remember, back in 1995 we did implement a gas marketing pilot that was pursuant to Vice President Gore's Reinvention of Government Initiative. MMS sold at that time by competitive bid at the lease approximately 45.6 billion cubic feet of gas from 14 lessees covering 79 leases in the Gulf of Mexico.

We saw a royalty loss of nine cents per MMBTU which overwhelmed a small administrative savings. I came before this Committee shortly thereafter about a year ago to present the results of that pilot. Despite what some might think as disheartening results of the pilot, we continued to pursue the notion of the Federal Government taking its royalty-in-kind.

And we have learned a substantial amount from that pilot. We learned that the voluntary nature of the pilot reduced our ability to aggregate and enhance volumes, that some of the downstream value benefits that are possible were not seen because of the way the gas was sold, and, finally, that the administrative relief was extremely limited because we continued to audit companies who had taken the gas in-kind.

The R-I-K study that we are currently doing has two primary objectives, and the real objective is to ensure that any R-I-K program is in the best interests of the United States and its taxpayers, meaning that we are looking for a program that would offer potential revenue neutrality or enhancement for the Treasury, and that would provide extensive administrative savings to both the Federal Government and the oil and gas industry.

I will tell you now that we have some preliminary findings, but they are only preliminary at this point. Our examination of R-I-K is ongoing. A major finding is that under favorable circumstances we believe that R-I-K programs could be workable, revenue neutral, or hopefully revenue positive, and administratively more efficient for both MMS and the industry.

The favorable circumstances that we see to be necessary would include an opportunity for us to participate in downstream marketing in sales which could enhance revenues, that would allow us to aggregate volumes, which we think could assure supply and could increase our market leverage, and, finally, a program that would provide administrative relief to both the Federal Government and to industry.

R-I-K programs would have reduced chance of success we think under some unfavorable circumstances, and the unfavorable circumstances that we have in mind are continuation of our auditing, producer's share of production. It would include any statutory language which would give the government less leverage in creating a workable R-I-K solution.

And another unfavorable circumstance would be if we were to try to put in place a R-I-K program for production that is scattered in many different basins with a decreasing potential for aggregation and would require an increasing amount of learning on our part.

Our challenge in the future will be to see if we can identify appropriate R-I-K programs that meet the favorable conditions that I have set forth, to develop a specific R-I-K program or programs for these conditions, and to conduct those programs and economic analyses associated with them.

In conclusion, as I mentioned before, we are enthused about the prospects for developing a R-I-K program or programs that could lead to success. And I agree with many of the witnesses before me by saying that success is defined as a program that is a win-win-win for all the parties that are involved.

However, because there are some inherent risks in any R-I-K program, we want to caution you not to move too quickly in trying to reach a legislative solution. We need to be able to conduct more detailed testing and analysis of any programs before there is broad application. If there is anything that the Subcommittee heard today, I think it would be the importance of flexibility in any sort of R-I-K program.

We caution that we not prematurely provide any legislative assistance that would seek to make a one-size-fits-all solution for R-I-K implementation in the future. We think success really relies on the ability to be flexible because the market has changed rapidly and quite a bit and will continue to change, we think, and we need to be able to change with the market.

Legislative initiatives may lock us into a R-I-K program that later turns out to be counter to the market and to the public interest. If we find that we need legislation after we have tested some pilots, we will be back to you and ask you for the appropriate legislative changes.

Considering the magnitude of Federal royalties, this issue I believe is too important for us to rush to judgment and to do it wrong. We are willing and excited about the prospects of working with the states and with industry to develop and test R-I-K programs that are amenable to all parties.

Madam Chairman, that concludes my prepared remarks with respect to R-I-K. I did want to make one note unrelated to R-I-K before I offer myself up to questions, and that is having sat here this afternoon, I noticed that there was one piece of information that seems to not be accurately communicated to the Committee. And I want to make sure that you were aware and that is with respect to our oil valuation rule.

There were some questions earlier and statements about the MMS attempting to move the point of valuation away from the wellhead, and that independents would not necessarily receive fair market price and would not be able to pay royalties according to that. That has been a concern of mine as well.

And I think if you were to go and read the rule, and I offer you up my staff, who is more expert than I am on this, to come and sit with members of the Subcommittee to talk and walk you through the rule, you will see that the discussion of NYMEX and ANS prices is a second step in the rule.

The first benchmark in the rule would permit a producer to pay on gross proceeds. If he has a contract for a sale at the lease, that is the first benchmark—the first place that we go forward. We are not interested in putting independents out of business here. So that is the first step.

And, again, as to NYMEX prices or ANS prices, I remind everyone that it is a proposed rule. That means that we are open to any other means of valuation that may be out there or other indexes that may be more appropriate. With that, thank you.

[Prepared statement of Ms. Quarterman may be found at end of hearing.]

Mrs. CUBIN. Thank you very much. I think one thing we can agree on—everyone is that the current is sort of a disaster. It is too expensive and it is too complicated, and, obviously, MMS having proposed a rulemakes a public pronouncement that we need change. You stated, Ms. Quarterman, that you have a huge volume of information from six workshops, and you have surveyed marketers, and you just have a vast amount of information on R-I-K. Do you need to gather more information, or do you have the information and you just need to analyze it?

Ms. QUARTERMAN. We are in the process of analyzing the information. We had a team from our policy shop perform the workshops and gather the information. They are in the process of drafting a final report which they will present to me shortly with a number of recommendations, I imagine.

Mrs. CUBIN. What would be an ideal situation for me is for MMS and industry and the states to be working together and get moving on this. It seems like it has been dragging to me. And I would really prefer a proposal to come from the work that all of you have done rather than legislation as you requested. Sometimes it seems though that we need legislation to get the ball rolling. So I would ask all of you to go ahead and get working on that, and let us make some progress and then the need won't sit up here. Mr. Dooley?

Mr. DOOLEY. Yes. Thank you, Madam Chairman, and thank you, Ms. Quarterman, for your really substantive testimony. It really was helpful in trying to come to grips on how we should move forward.

I guess what I would like to spend, you know, some time with though is on the rulemaking because maybe I have some misinformation. But from what I am hearing from a lot of my producers in California is that they are at least under the impression, unless there has been a modification to the rule that was proposed I guess on January 24, that a lot of their production was going to be priced based on an ANS benchmark or with a function of some adjustments based on sulphur content and a couple other issues. Now, is that incorrect?

Ms. QUARTERMAN. Well, first, there has been a modification to the rule since January when it was first published. We published a supplemental rulemaking less than 30 days ago. I don't know what specific producers you are referring to, but the modification would we think make the first provision of the rule, the gross proceeds provision, apply to many of the independents.

Mr. DOOLEY. And how would that differ now from the status quo?

Ms. QUARTERMAN. That is the status quo.

Mr. DOOLEY. And what producers then would fall under that?

Ms. QUARTERMAN. Any producer who is selling through a true arm's length sale at the wellhead would fall under that.

Mr. DOOLEY. And so that would mean that as long as a company wasn't vertically integrated that they would not be—they would be basically status quo in terms of their pricing?

Ms. QUARTERMAN. I would not go so far as to say if they are not vertically integrated. We haven't done the analysis to see exactly how many, if any, independents would have to pay under an ANS or a NYMEX scenario, but we don't think that there would be that many. The policy would be every single independent producer who doesn't have a refiner, but there would be quite a few who would be covered. Yes.

Mr. DOOLEY. And I guess then the objective was basically to some extent exempt the independents from this new methodology in terms of valuation?

Ms. QUARTERMAN. I would say independent producers, yes. When you say independents, there are a number. Yes.

Mr. DOOLEY. Right. Excuse me. OK. But that is, obviously, you know, a significant concern. I guess, you know, the definition of arm's length status though is still—you know, what does that mean I guess?

Ms. QUARTERMAN. It means you have a sale with a party who is not affiliated with you at the well.

Mr. DOOLEY. And how long does that have to be?

Ms. QUARTERMAN. How often is that——

Mr. DOOLEY. How long for that—you know, is that separation I guess from that party? Is that always—I mean, is there any—could there be a past relationship or that could impact, you know, whether or not that is defined as arm's length?

Ms. QUARTERMAN. I don't want to mislead you. Let me ask that I have my staff come in and give you a definition of an affiliate.

Mr. DOOLEY. Excuse me?

Ms. QUARTERMAN. I don't want to mislead you not having read the rule in about 3 months myself about what the definition of an affiliate is in the rule.

Mr. DOOLEY. And it is obviously what my concerns are here in terms—I just don't want—you know, some people are producing and primarily the smaller producers, you know, being placed with a valuation that is not necessarily reflective of what they are getting paid for. And that is the gravest concern we have with going to an ANS or a NYMEX benchmark.

You know, I don't care whether you are a large producer or a small producer. You know, sometimes, you know, we are concerned that that will not be an accurate reflection. And I guess that is the intriguing component of this payment-in-kind is that it reverses all of the incentives—is that everyone at that point—the producer and everyone else—has the incentive to maximize price opportunities and that benefits the Federal Government and the taxpayers, as well as the state government.

My question is if the Department and MMS is seriously considering going to a payment-in-kind as it appears that you are and you are receptive to that, you know, should we be, you know, moving forward with in some ways a fairly significant change in the royalty collection, you know, when we might be reinventing the process once again in the relatively, you know, near future?

Ms. QUARTERMAN. I don't want to mislead you by my testimony in saying that we are very enthusiastic about R-I-K does not mean that we think that we are at the point now or, in fact, we will ever be at the point where it will be appropriate to take all oil and gas in-kind.

I believe that the study that has been done shows that we should consider expanding the gas R-I-K program that was done in the past. There may be certain instances where it would be appropriate to consider taking oil in-kind. We have been approached by the State of Wyoming and have offered to work with them on the pilot project that they have in mind. So, in other words, we would still need a valuation system for that portion of the royalty that was not taken in-kind.

Mrs. CUBIN. Mr. Thornberry?

Mr. THORNBERRY. Thank you, Ms. Quarterman. I appreciate your testimony. If either of us sit back and look at what has happened over the past two or three years, I think MMS and the states and industry is all moving in the same direction. There is a little bit of difference on how fast we are moving and maybe what all is included, but I think the trend is definitely going toward royalty-in-kind.

And, obviously, I would hope that, as the Chairman said, as much as possible we could all work together in getting the best possible royalty-in-kind plan because it is, obviously, not going to do anybody any good if it increases administrative costs or if it increases lawsuits or if it doesn't give the taxpayer a fair return on the royalties that they are due. Then we haven't accomplished very much.

I am a little concerned about your last statement, and that is if basically you to use the expression cherry-pick what kinds of leases you want to put in a royalty-in-kind program, and some of them don't and so you have to still do the administrative evaluation for that, you hadn't really helped much of the administrative costs, have you? I mean, you still have got to have the folks to do that.

Ms. QUARTERMAN. Well, I think it is a fallacy to think the administrative savings are going to be the savings that are important here. I think the opportunity for revenue enhancement is the real winner. Our royalty program, as was mentioned at the beginning, is about $68 million a year, which is about a penny and a half for every dollar that we collect.

About 18 percent of that is collections that we do on behalf of Indian tribes. That, of course, would have to remain. We would still have to do collections for solid minerals and geothermal leases. We would have to create a royalty-in-kind program. The administrative savings are not going to be the real winner here I don't think. If there is a winner, it is that aggregating of volumes and enhancing the value downstream.

Mr. THORNBERRY. Well, except we have heard some testimony today about some remarkable differences in how many administrative folks it takes to keep up with certain programs. And so that is something that we need to work through, but the other winner—do you agree that another winner would be reduced litigation costs?

Ms. QUARTERMAN. Oh, absolutely. It would be. When you think about administrative savings, don't forget about the possible risks. As it stands right now, we bring in close to $5 billion a year. We collect that in royalties.

And basically we have 600 or so people in the royalty program who sit out in Denver, and we get $4 billion mailed into our office no matter what we do every year. If we were to take all that oil and gas in-kind, we put in jeopardy that $4 billion that we get every year without doing anything. So we really need to be careful in what we do, and that is all that I wanted to say to the Committee.

Mr. THORNBERRY. Yes, ma'am. I think you make a very good point, and, as I mentioned, we all want a program that works better, not worse. And we don't want to jeopardize the taxpayers. Let me ask you, one of the issues that I know you all got comments on in your meetings and is the subject of our discussion is whether it is mandatory or voluntary. What is your view on that subject—whether or not companies or even states can opt out?

Ms. QUARTERMAN. Well, I think if you want to be innovative that you need to be open to different ideas. I think it is clear under the existing Mineral Leasing Act and the OCS Lands Act that the Secretary can take oil or gas on demand is what the statute currently reads. So any variation or change in that statute some might view as a detriment to the taxpayer.

Having said that, I think that there are opportunities to work together with states and industry to work toward a solution that everybody can live with. But what we saw in the past was we didn't have enough volumes because it was voluntary.

Mr. THORNBERRY. Another point which in the notes from your meetings I understand that participants were unanimous about is that MMS take its royalty at the lease as far as delivery point goes. Do you think that makes sense? That is where it has to be?

Ms. QUARTERMAN. Well, it makes it more difficult for the government. I think under, again, the existing law and the leases onshore, it seems pretty clear that the government would have to take it at the lease offshore that we could ask a producer to bring it onshore and pay reasonable costs. Again, if you want to have an innovative program that everybody agrees to, you work those issues out, and you don't make any particular thing mandatory.

Mr. THORNBERRY. Let me ask you about one more. There was concern expressed I know about MMS getting involved in downstream marketing, and yet as I understood your testimony, you think that is an option that you want to keep in a royalty-in-kind program. Is that right?

Ms. QUARTERMAN. When you say MMS, that does not necessarily mean MMS employees. I do not think that the Federal Government employees that I have now would be capable of that, and the recommendations that I see coming forward would not include Federal Government employees doing that, but rather getting that skill from somebody else. It is easier when you are an outside person to stay up to speed on the market changes, and all those things would be necessary in order to market oil and gas.

Mr. THORNBERRY. But in that scenario, MMS would hire somebody or some entity?

Ms. QUARTERMAN. Definitely.

Mr. THORNBERRY. But the Federal Government would continue to own the product as it moved downstream to some point and could market it and sell it there rather than at the lease?

Ms. QUARTERMAN. Right.

Mr. THORNBERRY. OK. And that is something you think is good?

Ms. QUARTERMAN. Well, I think it is something we should explore. Again, there are the risks there because if something happens to that oil or gas along the way, we have lost it for the government. We don't own any pipelines, any storage space. You know, there are risks.

Mr. THORNBERRY. Yes, and there are concerns, as you know, from industry about getting the government involved in downstream marketing on particularly the amount of volume that the government could potentially bring in, that it would pose some danger to them as well.

Ms. QUARTERMAN. Yes. In the Gulf of Mexico, we have about 2.5 billion cubic feet of gas a day. I think that would make us the largest owner of gas in the Gulf.

Mr. THORNBERRY. Let me ask this final question. I understood and you have expressed to me before your concern about moving too quickly. If we do try to work with industry and the states to develop a R-I-K program in legislation, would the MMS folks be willing to work with us and offer their suggestions even if you were not to believe that sort of thing would be needed at that particular time?

In other words, I think it is important for us to have your input whether or not you think the timing is right. And would you be willing to work with us even if you thought the timing was not right?

Ms. QUARTERMAN. Well, certainly, we would work with you. Whether we would support you in the end is a different issue.

Mr. THORNBERRY. Fair enough. Thank you.

Mrs. CUBIN. Mr. Thornberry's questions raise some questions in my mind. I don't exactly understand why the $4 billion that just automatically comes in would be in jeopardy if we adopted a royalty-in-kind policy or a royalties-in-kind policy.

Ms. QUARTERMAN. Well, essentially, right now what happens is that oil and gas companies are required to pay us their royalty share, and that amounts to about $4 to $5 billion a year. And they mail in that amount and really what we argue about are things along the margin—potential increases to that amount, audit findings, verification of volumes, et cetera, which amount to another $100 or so million every year. That happens.

If we take our oil and gas in-kind, it means that we are now responsible for taking that oil or gas from the lease into the marketplace. We have to transport it. We have to sell it. We have to make sure that if it blows up, we have liability to cover any damage that is associated with it. It is a risk.

Mrs. CUBIN. But I really can't see why that is—of course, it is a risk. It is a risk to get up in the morning, but I don't see why it is a significant risk when you consider the fact that the government does have storage, for one thing. It is the strategic petroleum reserves. So, you know, there is storage available.

And if the companies or the producers don't have a market and can't sell it, then you are not going to be getting a royalty. I mean, I just think that is a real exaggerated view that all of that money is at risk. I think that the benefits certainly far outweigh that risk it would appear to me.

Then you said one other thing, and I just want to be sure I have this right. You weren't making or offering the opinion that you wouldn't want to take the mineral at the lease because it is more difficult for the government. That would not be the reason or any reason that you would not want to take the mineral at the lease. Is that right?

I think the statement you said when Mr. Thornberry asked about, "Then would you be willing to take the mineral at the lease?" and you said, "Well, it would certainly be a lot more difficult for the government to do that."

Ms. QUARTERMAN. No, no. I wasn't saying that we would not take it at the lease. I was saying that probably we would take it at the lease, and, in fact, onshore I think that is a requirement.

Mrs. CUBIN. OK. I just wanted to get that clear. Thank you. Mr. Brady?

Mr. BRADY. Thank you, Madam Chairman. As a Member of Congress, I would agree that it is a risk getting up in the morning around here. I had stepped out for a minute, and I only have two quick questions. So if I wander into an area that has already been covered, let me know please.

Thanks for the testimony. Thanks for hanging on through all this. You mentioned your reluctance to include all the oil and gas in the R-I-K program. And I know that in Texas over the years we have learned from the process in trying to improve all the time, and it has become clear that I think many of us would like to see legislation that provides for a staged process where we would stage in different regions so that we could accumulate and gather as much of that volume as possible. Are you supportive of a staged approach as we go forward?

Ms. QUARTERMAN. Without seeing what the stages are, it is hard for me to comment on that.

Mr. BRADY. Obviously, putting in place for both the agency and for the industry enough time and thought in different areas so that we are, in fact, gathering as many of those different wells and producers and all in order to gather all the oil and gas in the system.

Ms. QUARTERMAN. I suppose it is possible.

Mr. BRADY. And it would make sense sort of if——

Ms. QUARTERMAN. The stage approach could make sense, but it is hard to talk to without seeing it.

Mr. BRADY. Considering and thinking through some of the benefits of this system, including providing contracts for other government agencies using and bidding for these contracts, but thinking about the litigation, the time of that, the cost of that, especially the delay of that, I see the benefit of R-I-K providing, once we are up and moving, money to your pocket and taxpayers' pockets sooner and us gaining that increase of time value, of having the money in-pocket. Do you agree with that?

Ms. QUARTERMAN. There would be an increase in revenues for the time value of money for, again, the incremental amount that we would get from audit, not for the bulk of the money. And was there a first half to that question?

Mr. BRADY. No, it was just regarding the litigation costs——

Ms. QUARTERMAN. Oh, the litigation.

Mr. BRADY. [continuing] expenses, time, delay.

Ms. QUARTERMAN. Well, unfortunately, I am not as well staffed with attorneys as some of my adversaries. I think we have about four lawyers who work on royalty matters of the Interior Department. They also work with staff at the Justice Department on any Federal litigation. So the costs there are not as high as you might think.

Mr. BRADY. OK. Although I would say the Federal Government does pretty well with the lawyer pool. I think you all are pretty well covered in that area overall.

Ms. QUARTERMAN. Top notch.

Mr. BRADY. Just a thought. Thank you, Madam Chairman.

Mrs. CUBIN. Maybe if you told the Secretary that you needed those lawyers, he could free them up on that mineral bonding. Ms. Quarterman, the Ranking Member requested earlier, and so I will make the formal request to you if you would please do this—he asked that you would send to us a record of the estimated litigation costs so we would appreciate if you did.

Ms. QUARTERMAN. We will do that.

Mrs. CUBIN. Thank you very much and thank all of you for attending the hearing today and will look forward to working with you in the future. This Subcommittee stands adjourned.

[Whereupon, at 5:38 p.m., the Subcommittee was adjourned.]

HEARING ON: ROYALTY-IN-KIND FOR FEDERAL OIL AND GAS PRODUCTION (PART II)

THURSDAY, SEPTEMBER 18, 1997

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES, COMMITTEE ON RESOURCES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:15 p.m. in room 1334, Longworth House Office Building, Hon. Barbara Cubin (chairman of the subcommittee) presiding.

STATEMENT OF THE HON. WILLIAM M. "MAC" THORNBERRY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. THORNBERRY. [presiding] The hearing will come to order. Ms. Cubin has been detained in another markup, and she will join us later. And at this time, I would like to submit her opening statement into the record without objection.

[The prepared statement of Ms. Cubin follows:]

STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

The Subcommittee on Energy and Mineral Resources will come to order. The Subcommittee is meeting today to hear testimony on the Feasibility of Taking Federal Oil and Gas Royalties In Kind. Under Rule 4(g) of the Committee Rules, any oral opening statements at hearings are limited to the Chairman and the Ranking Minority Member. This will allow us to hear from our witnesses sooner and help Members keep to their schedules. Therefore, if other Members have statements, they can be included in the hearing record under unanimous consent.

The Subcommittee meets today to continue its review of issues concerning the collection of production royalties due the United States from Federal oil and gas leases onshore, and on the Outer Continental Shelf (OCS). This oversight follows upon our hearing of July 31st for which were unable to hear all witnesses identified by both the Minority and Majority as having meaningful views on R-I-K feasibility.

After today I am hopeful that the Subcommittee will have gained sufficient insight to begin a legislative initiative resulting in a workable R-I-K program at the Minerals Management Service (MMS).

As I said at the last hearing, my intent is to greatly diminish the enormous resources spent in the audit and enforcement functions of collecting royalty-in-value, because these costs are a loss to both the Federal and state treasuries. Yes, I understand the administrative costs of the Departments of the Interior necessary to conduct audits, bill lessees and then attempt to collect those bills is conducted with appropriated dollars, not direct spending.

Likewise, Justice Department costs associated with litigation over valuation disputes are subject to appropriation, and therefore the obvious savings that an R-I-K program ought to bring the government may not appear in a CBO analysis. But, my constituents in Wyoming, and I suspect Americans everywhere, don't care about arcane budget enforcement scoring rules. They, like me, simply want these royalties collected in the most efficient manner possible because that will result in a net gain for all.

I need not reiterate my opening statement from July. Suffice it to say there must be a better way to collect what is owed for the right to produce oil and gas from the public lands and the OCS. I trust the testimony from today's witnesses will help us in that endeavor.

Before I turn to our Ranking Member, Mr. Romero-Barceló, for any statement he may have, let me collectively welcome all our witnesses. I wish to especially thank Mr. Henderson who has traveled all the way from Calgary, Canada, to be with us today and shed light upon the private marketing of the Crown's oil produced in Alberta Province. I'm sure there are lessons we can learn from this system in designing a workable program for the U.S. As with the last hearing, I have asked the MMS to testify after other witnesses so that I can be sure the feds have listened intently to the preceding testimony, and perhaps gained some insights from it.

To wit, I am concerned about MMS' response to written questions which I posed in early August (and for which we have only yesterday received a response). It seems to me the general tone of the response to be "Remember, the Gulf of Mexico gas pilot lost money, so lets be exceedingly slow and cautious about doing more R-I-K."

I believe that analysis deserves further scrutiny before we take as gospel the MMS' extrapolation of an $82 million loss if all natural gas in the Gulf had been included. Besides, its time we climbed the learning curve and made another attempt to avoid the mistakes in the design of the 1995 pilot. Programs in Alberta and Texas both are apparently successful at adding value for those governments. Its time to get on with making it work for the benefit of all our citizens.

The Chair now recognizes the Ranking Minority Member for any statement he may have.

Mr. THORNBERRY. The Subcommittee is meeting today to hear testimony on the feasibility on taking Federal oil and gas royalties-in-kind. Under Rule 4(g) of the committee rules, any opening statements at hearings are limited to the chairman and ranking minority member. This will allow us to hear from our witnesses sooner and help members keep to their schedules. Therefore, if any other members also have statements, they can be included in the hearing record under unanimous consent.

I would like to thank Chairman Cubin for holding this hearing today. Royalty-in-kind is an issue that I have worked on for 2 years, and it is an issue that I believe deserves a lot of consideration by all the parties involved.

The subcommittee meets today to continue its review of issues concerning royalty-in-kind. This oversight hearing follows our hearing on July 31st for which we were unable to hear all the witnesses identified by the minority and majority as having meaningful views on RIK feasibility.

Today I am hopeful the subcommittee will have gained sufficient insight to begin a legislative initiative resulting in a workable RIK program at MMS.

Suffice it to say there must be a better way to collect what is owed for the right to produce oil and gas from public lands in OCS. I trust the testimony from today's witnesses will help us in that endeavor.

Let me collectively welcome all our witnesses. I want to especially thank Mr. Henderson, who has traveled all the way from Calgary, Canada to be with us and hopefully had, help shed light on the private marketing of the Crown's Oil produced in Alberta. I am sure that there are lessons we can learn from this system in designing a workable program for the U.S., and as with the last hearing, Ms. Cubin asked that MMS testify after other witnesses so that we can be sure that they have listened to the testimony and hear their comments on it.

Like Mrs. Cubin, I, too, am concerned about MMS' response to written questions that were posed in early August and for which the subcommittee only yesterday received a response. It seems to me that the general tone of the response is remember, the Gulf of Mexico gas pilot lost money, so let us be slow and careful about doing anything more. Personally, I believe the results of the Gulf of Mexico pilot project are invalid and have, call into serious question the, the worthiness of, of considering that pilot program. The lessons learned with the pilot—there were some lessons to be learned with the pilot project, but I believe those lessons could be entitled how not to administer a pilot project.

As many of you know, RIK is an important issue to me. For the record, I think that most of my colleagues at least know that 2 years ago, I was approached by the Texas General Land Office with a request to pursue RIK. I admit that at the time, it was something I was not familiar with, but after looking into it, I believe that it is something important for the country. In my view, a well-structured and developed RIK program would reduce the size of the Federal Government, eliminate burdensome paperwork for oil and gas industry, MMS and state governments, and provide additional revenue for the Federal Government.

When I first discussed this issue with the oil and gas industry and with MMS, there was a significant level of opposition from both sides. I am continuing to press forward, because I believe that RIK is in the best interest of the Federal Government and the industry and the taxpayers. Two years ago, RIK was going nowhere. This year again I reopened the file and tried to give it, tried to give it another try. I have been meeting with both MMS and representatives of the oil and gas industry and have requested their help and assistance in crafting legislation. I have indicated to both parties that I intend to introduce legislation at some point this fall, and it is my request that all interested parties assist us in making this program work as, as well as it possibly can. Frankly, we have had resistance from the industry. We have had resistance from MMS. But I believe it is worth pursuing and, and I need, we all need the assistance in making it work as, as well as possible.

Today I am again asking for assistance, because I believe it is in everyone, including MMS' best interest, to participate while the oil and gas industry is now talking with us about how to make RIK work. At times, they have been reluctant participants. But I believe it is the right thing to do and intend to pursue. And I certainly want to work with all those who are interested in completing this legislation.

Before we begin our testimony, I would turn it over to the ranking member for any comments he would like to make.

STATEMENT OF THE HON. CARLOS A. ROMERO-BARCELÓ, A DELEGATE IN CONGRESS FROM THE TERRITORY OF PUERTO RICO

Mr. ROMERO-BARCELÓ. Thank you, Mr. Chairman, and we appreciate the additional opportunity to review the potential for a royalty-in-kind program in the Federal oil and gas leasing program.

We believe that a great deal more analysis and assessment is required before we can responsibly determine whether or not legislation is required to impose the royalty-in-kind program on the Federal Government and the petroleum industry.

To focus our dialog on this issue, the minority has requested that the Congressional Research Service analyze the various issues attendant to the royalty-in-kind concept. With the agreement of the Chair, I would like to submit for the record a September 17 memorandum from the CRS, Congressional Research Service, addressing our questions.

And the CRS report discusses the major issues that would be involved in the establishment of a large-scale royalty-in-kind program in the United States. In summary, the CRS found, and I quote, that "RIK proponents contend that the system would reduce administrative costs and disagreements over the valuation of oil and gas production for royalty collections. However, such a system also would require an effective system for marketing the Federal Government's oil and gas and could lead to significant government involvement in oil and gas markets." As noted previously at our last hearing, our experience in Puerto Rico with involvement—involving the government in areas of market, marketing areas and private business has not been positive. It has been very, very poor experience, and we are privatizing again all of those services which were made into government services.

Also, at the Minority's request, we will hear today from three highly respected and exceptional individuals who do not work in the petroleum industry but who are also very knowledgeable on the structure, economics and trends in this dynamic sector. Mr. Tim Cohelan, Mr. Ed Rothschild and Ms. Danielle Brian each approach this issue from different perspectives and will provide the subcommittee with an objective and well-informed assessment of the royalty-in-kind concept.

And we commend the Minerals Management Service for taking such a positive yet a cautious approach to the royalty-in-kind concept in the September 2nd report which we will learn more about this afternoon.

The MMS proposal to conduct a good-sized pilot for natural gas in the Gulf of Mexico, built on the lessons learned in the 1995 effort, should provide quantitative and reliable information. Likewise, the proposals for ventures with Wyoming and Texas should produce valuable and necessary information.

And before moving forward with legislation, we need to determine that a royalty-in-kind program would be administratively feasible and fiscally sound. The detailed revenue impact analysis to be conducted by the MMS will assess the market risks and costs they would face in this new arena. We should allow them the time necessary to analyze the advantages and risks before we conclude that royalty-in-kind is a better way to more effectively—efficiently collect oil and gas royalties.

Meanwhile, we can and should continue our investigation into this area, and it is important that we have a clear understanding of the domestic oil and gas industry as it exists today, if we are to seriously consider privatizing the Federal program.

Thank you.

[The prepared statement of Mr. Romero-Barceló follows:]

STATEMENT OF HON. CARLOS ROMERO-BARCELÓ, A DELEGATE IN CONGRESS FROM THE TERRITORY OF PUERTO RICO

Madame Chair, we appreciate the additional opportunity to review the potential for a royalty-in-kind program in the Federal oil and gas leasing program.

We believe that a great deal more analysis and assessment is required before we can responsibly determine whether or not legislation is required to impose a "royalty-in-kind" program on the Federal Government and the petroleum industry.

To focus our dialog on this issue, the Minority has requested that the Congressional Research Service analyze the various issues attendant to the "royalty-in-kind" concept. With the agreement of the Chair, I would like to submit for the Record a September 17 Memorandum from the CRS addressing our questions.

The CRS report discusses the major issues that would be involved in the establishment of a large-scale royalty-in-kind program in the United States. In summary, the CRS found, and I quote, that "RIK proponents contend that the system would reduce administrative costs and disagreements over the valuation of oil and gas production for royalty collections. However, such a system also would require an effective system for marketing the Federal Government's oil and gas and could lead to significant government involvement in oil and gas markets." As noted previously at our last hearing, our experience in Puerto Rico with involving the government in private business has not been positive.

Also, at the Minority's request, we will hear today from three highly respected and exceptional individuals who do not work in the petroleum industry, but, who are also very knowledgeable on the structure, economics and trends in this dynamic sector. Mr. Tim Cohelan, Mr. Ed Rothschild and Ms. Danielle Bryan each approach this issue from different perspectives and will provide the Subcommittee with an objective and well informed assessment of the royalty-in-kind concept.

We commend the Minerals Management Service for taking such a positive yet cautious approach to the "royalty-in-kind" concept in its September 2 report which we will learn more about this afternoon.

The MMS proposal to conduct a good-sized pilot for natural gas in the Gulf of Mexico, built on the lessons learned in the 1995 effort, should provide quantitative and reliable information. Likewise the proposals for joint ventures with Wyoming and Texas should produce valuable and necessary information.

Before moving forward with legislation, we need to determine that a royalty-in kind program would be administratively feasible and fiscally sound. The detailed revenue impact analysis to be conducted by the MMS will assess the market risks and costs they would face in this new arena. We should allow them the time necessary to analyze the advantages and risks before we conclude that R-I-K is the "better way to more efficiently collect" oil and gas royalties.

Meanwhile, we can and should continue our investigation into this area. It is important that we have a clear understanding of the domestic oil and gas industry as it exists today, if we are to seriously consider privatizing the Federal program.

Thank you.

Mr. THORNBERRY. I thank the gentleman. Now I am going to introduce our first panel of witnesses. Mr. William Henderson, Market Development Representative, Gulf Canada Resources; Danielle Brian, Executive Director, Project on Government Oversight; Richard Rorschach, National Chairman, National Association of Royalty Owners; Ed Rothschild, Public Affairs Director, Citizen Action; Linden Smith, Managing Director, Barents Group; Timothy Cohelan, Cohelan & Koury; and Bob Neufeld, Vice President, Environmental & Government Relations, Wyoming Refining Company.

I believe all the, the witnesses are at the table. Let me remind our witnesses that under the committee rules, they must limit their oral statements to 5 minutes but that their entire statement will appear in the record. And we also want to allow the entire panel to testify, and then we will, we will have our questions.

Mr. Henderson, if you would like to lead off, sir.

STATEMENT OF WILLIAM HENDERSON, MARKET DEVELOPMENT REPRESENTATIVE, GULF CANADA RESOURCES

Mr. HENDERSON. Good afternoon. On behalf of Gulf Canada Resources Limited, it is my pleasure to be here this afternoon and give you Gulf's thoughts with respect to Alberta's current royalty-in-kind process for crude oil. I understand the Minerals Management Service is now debating whether to move to an in-kind type of system, and I hope my comments will be of some benefit to both the service and yourselves.

Alberta's royalty-in-kind process started in 1974 as a result of the energy price shocks in the early seventies together with jurisdictional issues involving the Federal provincial government over Canada's mineral resources. The in-kind process has undergone a number of changes throughout the years, the most recent being the move toward privatization. Previous to June 1996, the Alberta government used the services of 100 percent government agency, the Alberta Petroleum Marketing Commission, or APMC for short, to market the royalty share of crude oil.

As a result of government funding cutbacks and the general desire to get out of the business of being in business, the government turned the marketing responsibilities over to three agents, Gulf Canada being one of them. The decision to move to privatization using agency relationships took over 2 years and involved a number of studies and a great deal of industry consultation, much the same as you are going through now.

A number of different alternatives were exampled—or sorry, were examined including two variations of a cash royalty system. First, royalties would be based on the royalty payer's actual cash proceeds of sale. Second, they looked at royalties based on a series of reference prices ultimately netted back to the field location using the extensive quality and location data base maintained by the government. These reference prices were to be further adjusted by a market differential obtained through pricing surveys of producers. These two options were rejected by the government, as we believe that either one would, would result in less royalty revenue as compared to the in-kind system.

I should note that it was the first of these two options favored by larger industry producers, as these companies were very concerned about volume control. Smaller producers preferred an in-kind system and were generally—sorry, were generally in favor of the status quo. Privatization options including bid block sales were also examined but rejected by the government due to net back concerns and whether, in fact, the government was actually getting out of the sales business.

Finally, at the end of the review, the government opted on retaining the in-kind process using private sector agents to market the royalty oil instead of the APMC. Using revenue pooling principles, the government would be assured that it was receiving the same net backs as its agents while at the same time achieving its No. 1 objective of getting out of the sales business. With benchmark formulas built into the contracts, the government would also be assured the agents were receiving market prices for all sales. Also with ownership of the royalty volumes staying with the government until point of sale, the government could call upon its agents to undertake policy initiatives to protect the value of Alberta's resources or in making the production and marketing processes more efficient.

In the decision as to which agents to select, bids were solicited and reviewed based on a number of published criteria. Although not formally published, I believe one of the fundamental criteria was for the government to align itself with companies who had the same basic objective as the government, to maximize revenue. This is why Canadian producers such as Gulf Canada were chosen and large integrateds with refining operations, where pipeline companies with marketing arms were not.

The incorporation of the government volumes in the Gulf's marketing processes and systems was relatively painless. There was a large up-front data load required to get the appropriate data into our systems, but this was a one-time process.

As Crown volumes awarded to Gulf were of similar qualities to Gulf's existing volumes, the buyers were the same. The sales contracts were easily adjusted or signed. Day-to-day operational difficulties have been minimal with the only real troublesome spot being royalty volume forecasting. We have seen large volume swings between forecast and actual have, have resulted in some last minute scrambling, and we are currently working with the government to address this problem.

Gulf believes that both industry and the government have benefited from the recent privatization move. Government has achieved it is getting out of business objective while keeping its revenue streams intact if not enhanced. At the same time, it has been able to keep a relatively simple and straightforward in-kind process while not increasing administrative costs. Industry has benefited as it has not had to go through the pain of a major change in royalty systems. In fact, other than having to change the name of the organization to which reports are directed, there has been absolutely no change in industry administration.

In moving to agency relationships, the government was concerned that it would lose its window on market events and issues as it had with the APMC. This concern was unfounded, as Gulf has been very active in government liaison and maintaining the communication channels. For example, we were recently partnered with the government in a lengthy regulatory hearing regarding the reversal of the strategic Eastern Canadian pipeline.

In terms of benefits to Gulf, the most obvious and direct benefit we obtain is the marketing fee attached to the Crown barrels. The major indirect benefit is that with larger volume control, we are able to provide both the governments and our customers with increased service and more flexibility.

On a final and more subtle note, we are observing a large change in the structure of the oil and gas industry throughout North America. We see the Shell Texaco, Ashland Marathon and other mergers taking place. We see our producing competition from the south, Venezuela and Mexico, as huge nationalized producers. In order for Alberta to compete, it appears we too will have to become bigger. I think the province of Alberta realized this when choosing the agents it did.

Thank you.

[The prepared statement of Mr. Henderson may be found at end of hearing.]

Mr. THORNBERRY. Thank you. Ms. Brian.

STATEMENT OF DANIELLE BRIAN, EXECUTIVE DIRECTOR, PROJECT ON GOVERNMENT OVERSIGHT

Ms. BRIAN. Thank you very much. I ask that my written comments are submitted into the record.

I think it is important for us to sort of step back and remember why we are here. The reason we are considering any change in the royalty management program is that the government has finally recognized, along with other landowners, private landowners and states, that we have not been getting enough money for the crude that is produced on our land. As a result, the MMS finally recognized they needed to make a change, and they proposed a new rule in which they would actually be collecting more money. Suddenly, as a reaction to that suggestion, RIK came up as an idea that industry really wanted to pursue, but it absolutely fails to address the reasons why landowners have not been able to collect the money that was owed to them. It is really simply a diversion tactic from focusing on the real problem.

The reason that we landowners, we American citizen landowners, have not been getting enough money for crude produced on our land is that there is really no competition at the wellhead. As a result, we get the undervalued crude. RIK will not change this problem. We start talking about entirely different issues leaving the heart of the problem and the reason we are all involved in this exercise totally untouched. States and private royalty owners, when balancing the differences between RIK and being paid in value have chosen to go to the NYMEX system.

Mr. Thornberry, in his opening comments, referred to the fact that Texas was interested in RIK a couple of years ago. But now that they have really started evaluating the success of that system, Texas in their comments to the committee concluded the bottom line is that their state in-kind program would not exist if royalty payments were based on the market value of oil.

Another example from the states in deciding whether RIK was of value to them is when you look at California's success. I have four charts showing, actually it is Federal crude in California, and when you look at the differences in, in here we have at Midway Sunset, the differences between postings and RIK, they are getting the same prices. There was no success, no added value to going to RIK from postings.

There are four myths that I want to address in my oral statements. The first is the myth that RIK would mean more revenue to the government. This was initially industry's proposal, this would really be a better thing to do than the proposed rule. I have noticed in the last set of comments suddenly industry has moved, and now they are saying it is revenue neutral. They are no longer trying to claim it is going to be a revenue enhancer anymore.

MMS, in their feasibility study, pointed that out also, that when they asked marketers how is government really going to come out ahead? How are we going to be making more money? The marketers themselves could not give any convincing evidence the government was going to get anymore money by moving to RIK. These are the people who would be doing it, and they said they could not, could not explain it.

I am not opposed to RIK as a concept at all. I am simply suggesting that we go in with the pilot programs that MMS is already suggesting that we move in. There is really no reason to have legislation that would require a nationwide program and eliminate the opportunity to actually get paid for the market value of our oil.

The argument also that is being made as to why RIK would be better for the government is that we would be reducing the size of the MMS. But when you look at the numbers, the entire budget of the MMS is $60 million a year, and through their current auditing process, which I am the last person to defend, they are still making $125 million, and the proposed rule would actually, is estimated to increase that revenue by at least another $100 million. So if you eliminated MMS entirely through going to RIK, we have no government auditors for gas, oil, any of the other mineral royalties that they work on, you are still going to have to justify $225 million that is coming in through a value-based program, and RIK simply cannot do that by itself.

The other myth that I wanted to dispel is the fear that has been spread that independents would be forced to pay the market price or the NYMEX price even if they did not receive it. The revision to MMS' rule absolutely makes that concern baseless. If you see in the rule, they are given the option if an independent sells in an arm's-length transaction, they are given the option either of paying by, by NYMEX or gross proceeds. I was concerned about the independents' plight too, actually, and I thought that was really a terribly important distinction to make.

I wanted to just finally say that the argument also that the NYMEX does not reflect real prices is really extraordinary coming from an industry that uses NYMEX in all of their annual statements as a reflection of crude oil prices.

I am sure it is not lost on you that industry is in favor of RIK and opposes the new rule. Of course they are. They are interested in their bottom line and not ours. You cannot blame them for trying, but we certainly should not let them get away with it.

Thank you.

[The prepared statement of Ms. Brian may be found at end of hearing.]

Mr. THORNBERRY. Thank you. Mr. Rorschach.

STATEMENT OF RICHARD RORSCHACH, NATIONAL CHAIRMAN, NATIONAL ASSOCIATION OF ROYALTY OWNERS

Mr. RORSCHACH. Good afternoon, Chairman Thornberry and members of the committee. I am Richard Rorschach. I am an oil and gas lawyer from Kilgore, Texas. I am the national chairman of National Association of Royalty Owners. I am also the managing partner of Pentagon Oil Company which is a minerals management company. We own the minerals, and we manage them.

We are here today to talk about the royalty owners' comments concerning the changes to the current cash-based collection system and, and maybe to give the committee at least insight from, from the royalty owners' standpoint, at least the, the owners, private royalty owners' standpoint.

My organization, NARO, the National Association of Royalty Owners, has approximately 5,000 members. We also represent the interests of five major indian tribes, the Apache, the Navajo, the Sac and Fox, the Osage and the Chickashay—Chickasaw. We are dedicated to the needs of the nation's more than 4.5 million private royalty owners. There is 4.5 million of us kicking around this country. A large number of our members are over 70 years of age. They rely on their royalty income to supplement their Social Security checks. Most of us or many of us live in rural areas still. I live on a farm. We have a number of farmers and ranchers in our organization. They rely on their royalty check during periods of drought in the summer and, and bad weather in the wintertime to carry them through. The towns around which they live benefit from, from the royalty checks that come in, because these royalty owners spend their checks, and in fact, an oil country banker has said that royalty income is the financial heartbeat of the heartland. So you can see that royalty income is very important to the members of my organization and to 4.5 million people in this country.

We have wrestled with the problem of posted prices which is, is part of the problem for many years, and in recent years, the industry has become in disarray about pricing policies. Recently has, has been alluded to, there have been a number of lawsuits filed, probably the most publicized is the General Land Office suit in the state of Texas. However, there have been some other class action lawsuits filed throughout the country. Now it is apparent to me that as a result of these lawsuits that the last few nails are being nailed into the coffin of posted prices. We are going to have a new method to determine the value on which royalty is calculated. The question is what is the best method.

Well, we think that the best method is one that most easily determines the fair market value of the production and which generates the least amount of paperwork. Now let us look at a couple of things. The Minerals Management Service has about 61,000 wells on Federal land. Forty six thousand of those wells are low volume or marginally producing wells. That accounts for about 140,000 barrels of production a day. Now if we overburden the producers of these low margin, low margin wells, these low volume wells with onerous paperwork, you know what they are going to do? They are going to shut those wells in. We are going to lose 140,000 barrels of oil a day, and we cannot afford to do that.

I know most of you are familiar with the Commerce Department report that stated earlier in the year that imports, imported crude oil is, is a threat to our national security. If we lose that 140,000 barrels because of onerous paperwork, we are going to have to import 140,000 other barrels which, according to Commerce Department, is a threat to our national security.

But then, not only that, if all this paperwork is generated out in the field, it has got to come to Washington. People in Washington have got to look at it. That is going to—I do not know how many people. That is—you can remember the old Federal Power Commission days if, if some of you remember that, and the volumes, the truckloads of paperwork that came into Washington, some of which was never even looked at. I do not want to get into that situation.

Now how do we avoid this mass of paperwork and still receive a fair market value? Well, the royalty-in-kind may just be the answer to this. If we could—and, and I am not talking about the Federal Government taking and FISHKA physically taking possession of it, because they will think they have to. The MMS could set up auctions throughout the various parts of the country in which the MMS operates and auction off the crude once a month, once every 3 months, whatever, to qualified bidders who would—and what would you realize from that? One, you would realize the maximum price. At an auction, you are going to get the maximum price. The crude oil buyers are going to come in there and pay what they need to pay to get what they need. Two, you are going to reduce the paperwork. And three, you are not going to be required to hire on anymore personnel at the MMS.

Now you have heard the Canadian brother, and Canada processes 146,000 barrels of crude oil every day with 33 people. We have got 950 people in the MMS processing 204,000 barrels. We ought to be able to do as well as our Canadian brothers.

Our goal in my organization is we want to see the establishment of fair, accurate and workable pricing in royalty practice—reporting practices to the end that a true value for basing royalty calculations can be determined. We in NARO think that an RIK program, where feasible, it is not going to be feasible in all areas, but in the areas where it is feasible, is the way to go.

That concludes my comments. Thank you for your attention.

[The prepared statement of Mr. Rorschach may be found at end of hearing.]

Mr. THORNBERRY. Thank you, sir. Mr. Rothschild.

STATEMENT OF EDWIN S. ROTHSCHILD, PUBLIC AFFAIRS DIRECTOR, CITIZEN ACTION

Mr. ROTHSCHILD. Thank you, Mr. Chairman, and we do appreciate the opportunity to testify today on RIK.

Just some observations first, and the most intriguing of which is I have been doing energy work, energy policy work on the consumer side about 25 years. There are some people in the audience that know that quite well. And in all that time, there, all the time that MMS has been operating, all that time we have had Federal leases, there has been no charge or interest in moving to an RIK system. I think that only after the states particularly started suing oil companies for underpayment, and as a result settling as they have in Texas to pay on the basis of market prices based upon NYMEX prices, and that the MMS has suggested similar types of pricing, that all of a sudden, RIK—importance.

Now if the industry is so interested in RIK, then I have to say well, is this going to be good for the government? And the bottom line I think as a government official, as people working to protect the fiduciary responsibility of protecting the public's interest, the bottom line is simply which system or group of systems or combination of systems will generate fair market value for the public, for the U.S. Treasury. Not for royalty owners or private royalty owners, not for oil companies or gas producers or oil producers. They,

they will pursue their own interests. The job is to protect U.S. Treasury and the public's interest.

So what does that mean? Does that mean we should absolutely go mandatory RIK? Absolutely not. I do not think, from the evidence that I have seen, that an RIK program would fit everywhere. This is not a one-size-fits-all policy, and we should not go in that direction.

Now does that mean that RIK will not work in some areas? It may very well. I think there was, as Mr. Chairman you mentioned, a test. Was not a very good one. You are absolutely right. They had a lot of learning to do, and I think they have learned some lessons from that test. But we need a few more tests. This may very well work with respect to offshore natural gas, and if it does, if it is the best program to use for offshore natural gas, we should use it.

I also suspect, however, that it will not be that good for oil, particularly offshore oil. And there, I turn your attention to some of the tables in the testimony I have submitted. You can see the fact that there has been a severe decline in the number of oil producers, that the largest producers have remained stable over time, that the eight largest companies, you know, have been the eight largest companies for a long time, that the amount of U.S. production has remained fairly stable at or near 70 percent, and that they are the largest royalty payers on Federal land, the top 10 companies accounting in 1996 for 61 percent of oil royalties, which is not true on the natural gas side, where they only account for 42 percent of the royalties paid.

Secondly, in many cases, your transactions that occur with respect to oil, we see that there are not arms-length transactions, that there is no real competition for those sales. And that would put a very great burden on whether the government or some marketing outfit that the government hires tries to sell that oil. It is not likely to work. And so I do not think an RIK program in that situation makes a great deal of sense if you are not going to be able to assure that it is going to be a competitive price. And I think that has got to be the bottom line, and we heard the idea about an auction. An auction would be very nice, but if there is a single pipeline, if that pipeline is owned by the production company on the, on the lease, you have all sorts of structural problems, and if you do not really resolve those and account for those and deal with those, this kind of program is not going to work.

So the—I would point out also that the industry has made a great issue about the costs of marketing oil or gas. And I suspect those are, in most cases, fictitious. The—in their comments and response to questions from the committee, I point out that Texas, I think, said very clearly that in general, our leases require the lessee to deliver the product without deduction for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting and otherwise making the product ready for sale or use. That is what they do. That is what they have done clearly in all of these leases, and it seems to me that that ought to continue, that that is the job of the companies taking the oil from the lease.

Mr. Chairman, I will be happy to stop there and be willing to answer any questions.

[The prepared statement of Mr. Rothschild may be found at end of hearing.]

Mr. THORNBERRY. Thank you. A vote has just started, but I believe, Mr. Smith, if you would like to proceed, we will have time to do your testimony, and then we will probably have to go vote on an amendment on the floor.

STATEMENT OF LINDEN SMITH, MANAGING DIRECTOR, BARENTS GROUP

Mr. SMITH. OK, thank you. My name is Lin Smith, and I am a managing director of Barents Group LLC, a KPMG Company. I lead the firm's legislative and regulatory policy economics practice, and I am appearing today on behalf of 21 industry trade associations listed in my written statement. These associations represent producers of essentially all the oil and gas produced in the U.S.

I am here today to discuss how a permanent royalty-in-kind program can provide a net benefit to the Federal Government, the states and lessees, and specifically, to focus on some of the Federal policy and budgetary implications of an RIK program. Clearly, any serious legislative alternative will need to be scored CBO as being at least revenue neutral.

Several broad principles are important to keep in mind when considering a well-designed Federal royalty system. Some are basic to good government policy while others are specific to the Federal royalty area. I will raise just a few of these now, but I encourage you to read my written testimony.

First, it needs to be market driven. Paying royalties on fair market value is the principle that all parties in the debate accept. The issue is how to measure it. The most accurate measure of market value will be based on arm's-length prices actually received.

Second, it recognizes that value is added after oil and gas is produced. Various steps and processes are required to deliver crude oil and natural gas to its final destination that add value to the product. Adding value requires investment, results in cost and necessitates a market rate of return. It is no more appropriate to impose royalties on costs downstream of the lease, including downstream marketing costs, than it is to impose royalties on the cost of operating a gasoline station. Both add value to the product. Neither requires investment by the lessor. Neither is related to the lessor's mineral rights.

Third, it is perceived by all parties as providing fairness and equity to the Federal Government, state governments, producers, operators, marketers and refiners. If some parties do not believe they are being treated fairly, the credibility of the system will suffer, compliance will be reduced, investment and production will fall and the approach will have failed.

Fourth, it avoids economic distortion. Any government mandated approach that produces an inappropriate royalty value will distort investment and production decisions. This could occur if the effective royalty rate exceeds the contractual royalty rate with the use of a methodology that overstates market value.

Because it is market based, an RIK program at or near the lease meets each of these policy objectives. That is, by being responsive to market-driven changes and prices, it will capture the full value for Federal royalty purposes without a government induced distortion in investment choices.

Because the committee is not yet considering specific legislation, it is impossible to draw any firm conclusions about Federal budget effects other than to observe that the ultimate design matters greatly in achieving revenue neutrality. I would now like to mention a few of the more important design issues that matter for scorekeeping purposes.

First, does the proposal change current law? If legislation simply provides additional options to MMS, it is unlikely to be scored by CBO.

Second, will the RIK program be mandatory or voluntary? Scorekeepers are unlikely to score a voluntary program where MMS can choose which production to take in kind, because it can largely do that without legislation. They would likely score legislation allowing lessees to choose the RIK leases as causing a revenue loss. A well-designed, mandatory system avoids both results and would be scored.

Third, does the program create value for the Federal Government? Additional value can be created in a variety of ways, including allowing greater volumes to be aggregated, capturing a share of the value added by moving production downstream and capturing the benefits from increased competition. If these can be quantified by the scorekeepers, they will be scored.

Fourth, how will pipeline transportation costs be determine? Oil pipeline tariff rules are in a state of flux, and that makes it difficult for the scorekeepers to develop a current law budget baseline.

All I can say today is that the revenue impact of this issue is far from clear, and CBO must develop an official position on current law. Until we reach that point, the committee should carefully consider its policy objectives and work with CBO to see how they will score the issue. It is premature to simply conclude that pipeline transportation charges will result in a revenue loss.

I would like to make two other quick observations. The committee should focus on the net revenue impact of the comprehensive program. Any legislation will likely include revenue raising and losing provisions. Simply observing that one feature causes a revenue loss is not by itself a problem. A budget problem occurs only if aggregate losses exceed aggregate gains.

The other point is administrative cost savings will benefit both the U.S. and the states. Half the onshore oil and gas program cost savings under an RIK program will be shared with the states. Costs are minimized by a program that applies uniformly to all production. The states would get no cost reduction benefit from an RIK program just in the OCS.

In conclusion, a well-designed, mandatory RIK program has significant potential to increase economic efficiency, maintain Federal and state revenues, reduce controversy and be regarded as a fair approach for the Federal and state governments, lessees and the nation's taxpayers. It is possible for the committee to design an RIK program that applies to all production on Federal lands, onshore and offshore, for oil and for gas, it is in the aggregate at least revenue neutral.

Thank you.

[The prepared statement of Mr. Smith may be found at end of hearing.]

Mr. THORNBERRY. Thank you, sir. And if—the Subcommittee will stand in recess while we go vote right quick. This is a vote on Murtha-Tauzin amendment, and we should be back shortly.

[Recess.]

Mrs. CUBIN. This Subcommittee will come to order. I apologize for not being here. We always have conflicts while we are trying to do work the last few weeks of the session, so I do appreciate all of you being here. Thank you for your testimony for those of you who have already given your testimony, and I would like to call on Timothy Cohelan to give us his testimony at this time.

STATEMENT OF TIMOTHY COHELAN, ESQUIRE, COHELAN & KOURY

Mr. COHELAN. Thank you very much, Madam Chairman. Today I would like to focus in a general sense by way of background on the concerns that, that I have identified based upon my observations of the upstream and downstream markets. It appears that the, the deliberations and the discussion concerning the propriety of this RIK system is appearing in a series of market shifts that make it more difficult to, to analyze. It appears that again looking at California there has been a substantial consolidation of the downstream, that is from the refinery level to the street. Those trends basically include the consolidation of refinery ownership, the, the use of supply and exchange agreements and term sales in a way that has the effect of balancing off crude oil capacity as against market share.

And finally, there is a relationship with branding and branded marketing that as we sit here today has resulted in California in 95 percent of the motor gasoline being sold through seven or eight entities. There is a merger pending between the Shell and Texaco downstream operations that would mean seven. So we have a substantial consolidation of the entities that would be in the marketplace to purchase crude oil.

California's experience, I understand, is, is one that, that is, is similar in overall trends to that nationally. There is a national trend apparent to move toward refinery rationalization. Refinery rationalization as a process is one in which surplus refining capacity is generally aligned in a closer manner with the downstream markets. To the extent that this particular condition continues in the United States as a whole, it has implications for the marketing of crude oil.

In California, again returning to California, there has been an additional concentration of upstream. Upstream again are the, are the producing, producing properties both offshore and domestic. The ownership, as I think I mentioned in my, in my statements, the ownership mergers of upstream producing properties are going to result very soon in about 60 percent of the crude oil produced in California being marketed by just three companies.

Our unique situation in California may also apply in the sense that our crude oil reaches the markets. Again, the markets are primarily these refineries and are fewer of them. Basically, what happens is that the refineries will buy domestic and Alaska North

Slope crude oil for use in refining and manufacturing gasoline for sale. The decisions that are going to be made in California then are going to be made by those refineries. They are going to be—to the extent there is going to be fewer of them in the Northern and Southern California marketplaces, and to the extent that there is common ownership, it is going to be less of a competitive market. Well, that has a lot of implications for, for anyone that is talking about attempting to use a market mechanism, because when you look at a market mechanism as a substitute for something that seems to be working now, you got to ask yourself how many sellers there are and how many buyers there are, how they interact and what you are going to use to assign a value to that.

Basically, in California again on the downstream basis, we have what the economists call an oligopoly. That is a small number of sellers in a market. We have had, in my opinion, there have been anticompetitive characteristics that will be discussed in a civil action in, in the California court system. But the implication is that the decisionmaking for crude oil domestically in these markets will be made in a different way than it has been in the past. There are simply fewer refiners to participate in this market. All of our small refiners in California have been unable to make the conversions to manufacture motor gasoline, and so they are either providing feed stocks in some limited situations for other refiners, or they are entirely out of business, such as the Power Refinery which could not start.

So the larger companies, the larger manufacturers with the, with the larger refineries are in a position now where they make all those decisions, and their purchasing agents for crude oil are the ones, the traders that will be making these very important decisions with regard to what prices are paid. On natural gas, I would suggest that what I have read and, and learned from the regulatory authorities in California is that that is a different marketplace. There may be things about the commingling nature of, of natural gas royalties that make it a fairer measure. There is apparently other interactions in market centers that have been established that may make that a better candidate for some kind of an RIK approach.

But I would like to, if nothing else, point out how dangerous I think it might be to adopt a national, a national policy without looking at the implications in local markets. The second major point I would like to make is you are talking about a moving target. Every day there are new mergers downstream and upstream, and the marketplaces in which you are going to place the government under such a program is changing drastically. And finally, your review, in my humble opinion, should be done with your fiduciary duty hat on, and you ought to have very substantial and compelling reasons that the taxpayers and the, and the people who are ultimately receiving this benefit are going to be better off as a policy, and we ought to go a little farther than just identifying administrative burden.

Thank you very much for inviting me here today, and I will be available for questioning.

[The prepared statement of Mr. Cohelan may be found at end of hearing.]

Mrs. CUBIN. Thank you for your testimony. I would like to welcome Mr. Neufeld from my home state of Wyoming and ask if you would please present us your testimony now.

STATEMENT OF BOB NEUFELD, VICE PRESIDENT, ENVIRONMENT & GOVERNMENT RELATIONS, WYOMING REFINING COMPANY

Mr. NEUFELD. Thank you, Madam Chairman, members of the Committee. My name is Bob Neufeld. I am the Vice President of Environment & Governmental Relations for Wyoming Refining Company. I am here today because I want to tell the committee about how the Minerals Management Service is driving my company toward bankruptcy, is inflicting serious damage on other small refiners in the country and is destroying a Congressionally authorized program that has been operating successfully since 1946.

I think the committee would like to hear what I have to say, because our experience with the Minerals Management Service and the currently authorized small refiner royalty-in-kind program will shed some new perspective on why 20/20 hindsight, armchair quarterbacking, second-guessing and post-hoc valuations have no place in the determination of the value of Federal crude oil and will lead you to the common sense conclusion that the only fair and equitable way to really know that you are getting market value for your oil is to market the oil.

Wyoming Refining Company is a small 12,500 barrel a day refinery in Newcastle, Wyoming. We are, nevertheless, the largest private employer in Weston County, Wyoming. We provide about 50 percent of the motor fuel supply for the Black Hills region of Wyoming and South Dakota, and over the last, I would say, 10 years or longer, we have provided about 90 percent of the jet fuel supply for Ellsworth Air Force Base in Rapid City, South Dakota. Our demise would have serious implications for that region of the country in terms of availability of refined motor fuel products and possibly national defense implications as well.

The royalty-in-kind program in which we participate was authorized by Congress in 1946, and it operates this way. When the Secretary of Interior determines that adequate supplies of crude oil are not available to small refiners, the royalty is taken in-kind from select leases and sold to small refiners. And historically, that has been at prices reported by the producer. The purpose of this is to be sure that large, vertically integrated oil companies do not have exclusive access to Federal crude oil and that small refiners are around to provide a stable supply of national defense fuel supplies.

We have been in the program since about 1980, and historically over the last 10 years, it has provided about 40 percent of our crude oil supply. And everything was fine until 1995, when we got a demand letter from the Minerals Management Service that said we have audited the producer, we think the producer has undervalued the oil that we sold you between 1987 and 1992, (that is as much as 8 years prior to the letter) and because the producer, we think, undervalued the oil, you owe us another $2.5 million.

We could not understand how we could owe $2.5 million for somebody else's alleged mistake, and we filed an appeal bond to appeal the matter to the Minerals Management Service director. The—we have subsequently learned that other leases from which we purchase royalty oil are under review and that at the present count, we may owe another $4.5 million. Our banks have told us that if that letter, demand letter issues, we will be taken involuntarily into bankruptcy.

The lessons to be learned from this are threefold. No. 1, we think the damage that is being done is that the Minerals Management Service has denied us our opportunity to cancel the contract. When we receive a delivery of oil, and then the invoice comes 45 days later, we have to pay for that oil, but if we do not like the price, we can cancel future deliveries. But if we do not find out what the real price of the oil is going to be until 8 years after the delivery, we have no chance to cancel those deliveries. They forced us to purchase oil. Their position is they can force us to purchase oil we would not otherwise purchase, and in fact, we would have refused delivery on.

Secondly, and it is what is most egregious about this, is that we have evidence, and it is clear from the case against the producer, that MMS suspected the prices that it was billing us for on this oil were incorrect as early as 2—1 year into our audit period, as early as early 1988 or 1990—1989, excuse me. Nevertheless, even though they suspected that the prices that the producer were reporting might be incorrect, they continued to repeat those prices in our invoice and continued to sell us oil. In other words, they stood back and watched us continue to buy this oil when they should have known that it was increasing our contingent liability and our exposure under a future audit of the producer.

And third, and this one is almost as egregious as the second, is that we spent somewhere in the neighborhood of $250,000, which is a big amount for a company of 95 employees, trying to defend the producer's valuations in this matter. MMS has said: It does not matter what your evidence is. We had a case over here with the producer where we did the audit, and that is where we determined what the value is, and we are going to bind you to it. So apparently, MMS has determined that there is, in fact, an exemption to the due process clause of the Constitution for small refiners who are allowed to unknowingly purchase oil that they could not afford and would not have otherwise purchased.

My conclusion is that we think that MMS is confused as to whether or not it is selling oil or collecting royalty, and it cannot do both. If it is going to sell oil, it has to do it in an arm's-length transaction. That is not what is happening here. Every purchase that we make under this program is a contingent liability. There must be some finality in the price of oil when it is sold. You cannot go on for ever and ever knowing that, not knowing what the price is going to be. The consequences go beyond the producers. It goes to our consumers and to our employees. And again, I would remind you that the only way—we feel that the only way to know what the market value of the oil is is to take the oil and market it.

Madam Chairman, one final comment. I would like to say that Gary–Williams Refining, Age Refining of Texas, Placid Refining of, of Texas and Louisiana and Giant Industries have authorized me to say they concur in my remarks and have added, given me some additional testimony statement that they would like to have submitted to the record.

[The prepared statement of Mr. Neufeld may be found at end of hearing.]

Mrs. CUBIN. Without objection, it will be so ordered.

I thank the panel for their testimony, and now we will go to the questioning portion of the hearing. I want to remind the members that according to the Committee Rule 3(c), we have a 5-minute limit on our questioning and ask that they will hold to that as much as they can, and then if their questions are not all asked and answered, and members want a second round of questioning, then we will grant that as well.

So to begin questioning, I will call on the Ranking Member, Mr. Romero-Barceló.

Mr. ROMERO-BARCELÓ. Thank you, Madam Chair. I thank the panel for their testimony and for helping us try to figure out something, what is the best that we can do as far as the—and the states are concerned. And I believe that each one of you would agree that even though there, while there are many benefits associated with going to a royalty-in-kind program, that there are also risks that must be recognized and which should be resolved before implementing such a radical change. And which one would each, each of you believe it to be the greatest risk associated with a national in-kind program? And can we go from left to right and start over here?

Mr. HENDERSON. I am sorry, your question was?

Mr. ROMERO-BARCELÓ. Which do you believe that the greatest risk that would be associated with, in a national in-kind, a royalty-in-kind program? Or, or maybe you do not accept that there are any risks at all. If you do, which one you think is the greatest risk?

Mr. HENDERSON. I, I cannot speak from, from the U.S. perspective, and I can just give you an indication of what I saw happen in Canada over the last 3 years. One of the biggest concerns that the, the government had in, in maintaining the in-kind system was in fact that it was not achieving market value for its crude. I think from that perspective, that is why it went to an agency basis and the pooling of revenue concept so that would, in fact, ensure that it was receiving market value. Together with our contracts, they have benchmarks built in to, to test against market, general market prices.

Mr. ROMERO-BARCELÓ. Thank you. Ms. Brian.

Ms. BRIAN. I think that is similar to my comment. I think that by far the biggest risk is that we would then think we fixed the problem and moved on, and we in fact would not have done anything toward fixing the problem in the government getting market value for its crude.

Mr. ROMERO-BARCELÓ. Thank you, Ms. Brian. Mr. Rorschach.

Mr. RORSCHACH. I, I do not, I do not see any very big risks. The only, only problem I see is in some areas, and I am not familiar with, with Federal leases, in small Federal leases, if there are such thing, that it might, a royalty-in-kind program might be a problem, because it would be very difficult to, to aggregate crude so it could be taken in-kind. In large leases, no problem there at all. So the only, only problem or a risk, if you want to call it that, would be in, in small leases, small in area.

Mr. ROMERO-BARCELÓ. Thank you, Mr. Rorschach. Mr. Rothschild.

Mr. ROTHSCHILD. I think it is the problem of having one shoe fitting all sizes, and I think the, as my testimony made clear, while an royalty-in-kind program may be appropriate, may work well in some areas, it may be horrible in others. And therefore, I think the idea of having a mandatory program is inappropriate, and I think a structured program that applies it in the right places and not in the wrong places probably makes more sense.

And second, I think the irony here is all of a sudden we are, you know, we are trying to get the government out of the oil business, as we are in selling off Naval petroleum reserves, and all of a sudden here, a national program, if it is mandatory, would put the government in a, in a huge way into the oil business, and I think you got to consider that as well.

Mr. ROMERO-BARCELÓ. Thank you, Mr. Rothschild. Mr. Smith.

Mr. SMITH. Thank you. My, my reaction would be that I would be concerned if we moved too quickly without giving consideration to the operational design of the program. There are an awful lot of details that must be addressed in looking at this kind of program that need to be worked through very carefully, and I would view this as something where the MMS and industry and the committee have to work together to get these details right. I think that if that cooperation exists and that willingness to work together exists that we can come up with a workable program, but the risk is one of, of moving too fast or not working on, together with good faith to try to resolve these many issues that, in fact, do have to be considered carefully.

Mr. ROMERO-BARCELÓ. Thank you, Mr. Smith. Mr. Cohelan.

Mr. COHELAN. Yes, very briefly, I think the, the major risk is that there would be a substantial revenue loss. The revenue loss would then require continued public discussion. Continued public discussion would revisit. There would be new hearings. There would be a re-examination. Following up on what Mr. Smith said, if the appropriate time and consideration is given, given, including but not limited to the differences in geographic markets and the hardship cases that you are hearing about here today, then I think you can minimize that. But a revenue loss by a precipitous enactment of a national mandatory RIK is something that would just occasion a continued debate by the representatives of the public and so on.

The fact that there is a dispute today is a function of their disagreement over valuation. We all like to see disputes minimized. We have a civilized society and a good governmental structure where we resolve disputes in a focused and intelligent way, and our system of government is better at it than any other. We should not run away from this just because there is disputes. There should be—hard cases generally make bad law. Somebody ought to be looking at, at the administrative processes and problems that somebody like Mr. Neufeld is having and then make a determination whether you have a sufficient degree of administrative relief in the system. But when you look at 140,000 barrels a day as an example of national production, and then you look at a small refinery as a, as a focal point for a description of a very large problem, what you really want to do is, is help those people in, in their individual circumstances and assist them in a systematic way that does not require you to re-engineer the whole system.

Mr. ROMERO-BARCELÓ. Thank you, Mr.—Mr. Neufeld.

Mr. NEUFELD. From the other side of the fence as a purchaser of the crude oil, we cannot see any risks in an RIK program that match the risks involved in the current policy of deliver and reprice. We would like to be sure, however, that small refiners continue to have an equal opportunity to compete for the oil and perhaps a right of first refusal in which the best price, if it is put up for bid, the small refiner has an opportunity to match that price and purchase it at the same price as the winner.

Mr. ROMERO-BARCELÓ. Thank you very much.

Mrs. CUBIN. You want to go last? Mr. Duncan, are you prepared at this time to ask questions?

Mr. DUNCAN. Well, I will tell you, I know the least about this of anybody here, but what I want to ask is this. I am—and I did not get to hear all of the testimony. But I see that Mr. Rorschach said in his testimony today the average Mom and Pop business in the oil field is the operation of marginally producing or low-volume wells. These operators are now totally over their heads with regulations and Federal environmental requirements. And I guess my question is are we, are we heading in a direction toward more regulations and more paperwork? Is that what you are concerned about?

Mr. RORSCHACH. Yes, sir. If, if you go to, if you go to a system that is going to require more and more reporting to—and my, my thing is if you go to an, an RIK program, you are going to get rid of just practically all the reporting that you would have that would be required by another system.

Mr. DUNCAN. If, if we go to a royalty-in-kind program, you, you think that we could do away with a lot of the paperwork? Is that what you are saying?

Mr. RORSCHACH. I do not think there is any question about it.

Mr. DUNCAN. And, and——

Mr. RORSCHACH. As opposed to some, some of the, as opposed to some of the methods that are currently proposed in the proposed rules.

Mr. DUNCAN. And that would, and that would help the small businesses in this——

Mr. RORSCHACH. I—as I said in my testimony, I think if you, if you put anymore burden on, on the, on the marginal well operators, they are just going to shut them in, turn them to the right and walk away.

Mr. DUNCAN. When I see your testimony that you are over your head with the environmental requirements, it seems to me that these environmental extremists have become the greatest ally to extremely big business. And, and they are doing terrible harm to small businesses. And, and I would like to see us provide more assistance to the small businesses, and so I, I like your testimony.

Mr. RORSCHACH. Thank you.

Mr. DUNCAN. Thank you.

Ms. BRIAN. Mr. Duncan, could I, could I——

Mr. DUNCAN. Thank you, Madam Chair.

Ms. BRIAN. [continuing] could I make one comment on, on Mr. Duncan's question please?

Mrs. CUBIN. Certainly.

Ms. BRIAN. Thank you. I just wanted to clarify one point. The—what we are talking about is RIK on Federal leases. It is really not going to have anything to do with the landowners that we are talking about who are suffering. What we are talking about here is RIK on, on Federal crude.

And the second point is that, that what we are talking about is an alternative to the current system that everyone hates, going to a NYMEX system which is publicly disclosed every day where we would have less dispute over value, because we would have the market telling all of us when we open the paper exactly what we are talking about, so it would actually be resulting in less paperwork.

Mr. RORSCHACH. If I might respond just briefly, you are talking about—we—I understand you are talking about Federal leases. It has been my experience, and I have been around this oil patch for 35 years, that anytime a Federal program gets initiated before very long, that camel's nose is into the private owner's tent. And we want to prevent that if we can.

Mr. DUNCAN. Well, all I have noticed is that the more you regulate an industry, and the more paperwork you require, the more it ends up in the hands of a few big giants. And I do not care what the industry is. It, it happens in everything and, and if we go in the direction of more and more regulation and more and more paperwork and more and more red tape, and we have gone way overboard on some of these environmental regulations, as you point out in your testimony, and if we keep going in that direction, we are going to drive all the small guys out of any of these major industries. And I will tell you, we are going to be really sorry if we do that.

Mr. NEUFELD. Madam Chairman——

Mr. RORSCHACH. I think you and I are looking through the same knothole.

Mr. DUNCAN. Thank you. That is all.

Mr. NEUFELD. Madam Chairman, I, I might have an additional perspective to add to that if I might—over here on the end. As a person who buys Federal crude oil, we found that the process of purchasing Federal crude oil under the current system is much more complicated than our ordinary purchases. And anything that makes it as simple to buy Federal royalty oil as ordinary purchases will be worthwhile and an improvement. I am beginning to think, after our current experience with the Minerals Management Service, that EPA is like a walk in the park, frankly.

Mr. ROTHSCHILD. Madam Chairman, could I just add one thing?

Mrs. CUBIN. As long as that light is green, you——

Mr. ROTHSCHILD. OK.

Mrs. CUBIN. [continuing] you all can have this day. I am going to ask you, Mr. Smith, as well, as long as that light is green, we are still on Mr. Duncan's time.

Mr. ROTHSCHILD. In Mr. Rorschach's comments, he pointed out that the posted price was too low. That is one of the problems that has been occurring in the industry, and the question I would have is why that happened. And our view of it is that if you do not have very much competition in the industry, he may want to explain that. Second, it was the state of Texas, for example, instead of California, instead of Alaska, that intervened on behalf of, and particularly in Texas, on behalf of all the royalty owners, the state and the private royalty owners, to collect underpayments. So you know, I am very intrigued, and I am also intrigued by Wyoming Refining, you know. Here we have a program that is a government effect, a government subsidy for small refiners, not one that I would dispute. But that is what it is, because it keeps them in business.

So on the one hand, you do have the government playing a positive role. On the other one, I can understand why he is upset about what has happened. But we ought to keep in mind that the reason that the government program is there is to be able to get crude to his company which he says is as much as 40 percent of his usage.

Unidentified Speaker. I will dispute the—comment.

Mrs. CUBIN. However, he could have, he could have not purchased that oil and would have not purchased that oil——

Mr. ROTHSCHILD. I understand that.

Mrs. CUBIN. [continuing] had MMS given them any, any indication that this might be the end result. I just have to add that in trying to be impartial here.

Mr. John.

Mr. JOHN. Thank you, Madam Chairman. I, I want to, I want to thank the, the committee and the subcommittee for undertaking this debate, because I think it is very important. I think everybody in this room today, as I look across the audience, believe that, that the system that we have in place is, is somewhat burdensome, cumbersome and full of paperwork. And I think that the bottom line, as we were discussing here, is to balance the risk versus the benefits of changing the system.

Ms. Brian was pretty definitive in her remarks about and her opposition to an RIK program. And Mr.—the gentleman from Puerto Rico asked her, asked Ms. Brian what do you feel this is obviously the, the biggest risk, and you said getting the fair market value of it, of our crude and making sure that the Federal and the state governments are getting the best price that they possibly can. Do you feel that the system intact today does that?

Ms. BRIAN. Oh, no, no. First I would like to say I, I specifically was not definitive in my opening statements. I hope I did not make that point or appear to be definitively opposed to RIK. I am definitively opposed to a nationwide RIK program. I think, for example, in Wyoming, it sounds before this hearing, I have understood that there really are a lot of reasons why maybe Wyoming would be a great pilot program. So I am not in any way opposed on principle to RIK at all. My concern is this, this absolute, nationwide, mandatory program.

But what I certainly would never do, and I have spent the last 3 or 4 years actually attacking, is defend the current system. I have four reports that we have written showing how the current system has failed and how the Federal Government alone has been owed as much as $3 billion that has not been collected because of the fact that Federal crude has been undervalued.

So what we really do believe, however, is that the appropriate response is what MMS is proposing. And I frankly find it remarkable that I am here saying that, but I think that by moving to a market-based valuation system, where we do not have an arbitrary posting, which is what we exist with now, that is made up. It is not in fact the value of the crude that we are getting paid on. If you have a NYMEX or something based on the NYMEX, and you take into account the transportation costs, which is absolutely reasonable. This calculation has been used before and would go on under an RIK program too. That would simplify things. We would have an open price that everyone would know what it was. It would not be under dispute. And then we would be getting towards collecting the money that is owed to us.

Mr. JOHN. Would you agree that the best possible price is the actual price at which you could get for that crude?

Ms. BRIAN. Not the price the Federal Government has been getting. It certainly is not the best possible price, no.

Mr. JOHN. Well, I think—well, I just believe that we need to proceed carefully and slowly, and I think that was reiterated through the panel today, about looking at this. My state of Louisiana has lots of interest in what is happening here. My district is oil and gas and dependent on that industry. So I am, I am taking a look at this and, and making sure that we do just the right thing. And, and I along with Mr. Duncan just believe that we can make it more simple, more—less litigious. In a lot of the, the situations that we run into, we are in court battling over the, the prices and, and the well and the wellhead and arm's-length and, and all of the other litigation that happens with it. I think that the, the RIK program has some merit, and I think we need to move forward on it.

Mrs. CUBIN. Thank you, Mr. John. Mr. Thornberry.

Mr. THORNBERRY. Mr. Smith, let me start with you. You did not really get into this much in your testimony, but you have had considerable experience in the government in estimating the revenue effects of, of different things that the Federal Government has done and, and your testimony, I think, as a matter of fact, you are as qualified as anybody outside of government to, to look at these things. Your testimony said that it all depends on how the program is written on, on the revenue coming back into the government. But I wanted to ask you, if it is done, is there anything that you have seen in what you have looked at that says that there is no way to develop an RIK program that will not be at least revenue neutral. I mean is there any impediment that is just going to prevent that from happening? That you have seen.

Mr. SMITH. I think—oh, I am sorry. Well, first of all, before—one thing I would like to add, I am here representing now 22 associations. The Louisiana Independent Oil and Gas Association has signed on to this as well, and I just wanted to get that in the record.

In terms of impediments, no, I do not believe there is any impediments to a revenue neutral program being designed as long as it is carefully considered, and the budget scorekeeping effects of specific decisions are taken into account. Can you design an RIK program that loses money? Absolutely you can design one that loses money. Can you avoid having one that loses money by, loses money by carefully designing it? Yes, you can, as you can come up with a program that does accomplish your objectives of being at least revenue neutral through careful design and consideration of its features.

Mr. THORNBERRY. Thank you. Now you have heard a great deal of discussion from just about every member of the panel today about how difficult it is to figure out what the market price of, of oil or gas is. And you have heard everything from the government coming back 8 years later, or whatever it was, to say that is really not what the price was. You have heard the difficulties of some people allege that we have not gotten nearly as much as we should have in the past. All of these disputes about the market price. Can you tell me what would be better to figure out the market price of it than actually the market itself?

Mr. SMITH. I do not think there is anything that is better than the market itself. That is if we look at an RIK program where a significant share of production, in this case one-eighth of onshore production, one-sixth of offshore production, is taken in-kind, we are going to have a large new supply thrown out to the marketplace up for bid. And that bidding process is going to result in a determination of, in fact, a fair market value price. And so I think this is exactly the kind of direction we want to go in to come up with the correct measurement of price.

Mr. THORNBERRY. Well, why can you not use a one national price all across the board that is posted so everybody knows what it is? Why does that not work?

Mr. SMITH. Well, I assume you are referring to something like NYMEX. And the problem with NYMEX is NYMEX is what is called a derivative price. It derives its value from the underlying cash markets. It is trying—and it is trying to use that to anticipate what prices will be in the future. NYMEX, NYMEX is basically for trading on a futures contract for a paper barrel of crude oil. And so you are using something that comes from a cash market to forecast what a paper barrel would be worth in the future, and you are trying to turn that around and apply that back to cash markets again. You get into this circularity issue which is just sort of a crazy approach to trying to establish a price. The real price is what a willing buyer will pay a willing seller for a quantity of any product. And I would again say that if you put a large volume of production out for bid, you will get a market price. That will be the best measure there is of the, of the true market value of the, the product.

Mr. THORNBERRY. Thank you. Mr. Cohelan, I notice that, that you are with a law firm in San Diego specializing in class action suits and have, have done a lot of plaintiffs' work in litigation over the last few years. From, from your background as, as being a trial lawyer, do you not think that if we could have an RIK program we could at least reduce the amount of litigation that is, is just eating us up from the government and private sector fighting about what the price of oil is and was?

Mr. COHELAN. Well, I think the short answer is yes if you, if you define it right. You, you mentioned why do we not use the market to define the prices. Of course, that is, that is saying a whole bunch, because the problem is what is the market. The, the NYMEX, use of the NYMEX is an effort, imperfect though it is, to establish objective benchmarks. People in good faith, you know, using old Adam Smith's invisible hand are seeking their own interests, and that is great. That is what made our country what it is. The problem is when you rub up against public policy, you got to look more closely at those markets and ask yourself if you are getting a fair market value. If you had an objective benchmark, and you perhaps add some kind of arbitration procedure, you could take this stuff out of the courts pretty easily. The reason it is in the courts right now is that people of good will on both sides have real strong disagreements over what fair market value is, and you get around that by getting something out of their hands that defines fair market value like a NYMEX or ANS crude price.

Mr. THORNBERRY. Well, thank you. It seems, going back to what we were just talking about, I do not see how you can improve on the actual market.

Mr. Henderson, let me ask you, before my time runs out, in Canada, you all have lots of lawsuits?

Mr. HENDERSON. No, we do not.

Mr. THORNBERRY. And out of the, let us see, you have 36 people administering this program as I understood. Was that about what it was, your, your testimony? You had about thirty some odd people and, and you do not have a bunch of other lawyer—see, the problem we have got in, in MMS is we have got a lot of other lawyers throughout the Department of Interior that are involved in these lawsuits, and it is hard to figure out exactly how many people are involved in all of the litigation that arises. Do you all have that problem?

Mr. HENDERSON. I, I do not see that problem arising in Canada where we have got, and you say 30 people. I, I am not quite sure what the government has over there now. I know when they made the transition to, to the private, private sector, there was about 10 people that moved over into the private sector with that.

In terms of lawsuits, the government is administering three contracts up there with three agents, and when you have that few of contracts, and when you have good relationships, you are not going to have the problems you see, particularly on the marketing side.

Mrs. CUBIN. Thank you. We have a vote on the Tauzin amendment to the ethics legislation that is before the Congress, so we will go vote, and we will be right back. Two more people on this round of questioning, and then we will see if we need another round.

[Recess.]

Mrs. CUBIN. I ask the panel to take their seats please. Mr. Dooley, would you care to begin your questioning?

Mr. DOOLEY. Yes, thank you. I thank all the panelists for coming today.

Mr. Henderson, I was interested in your testimony where you talked about in the case of Alberta they considered a number of different options, and they made a decision really stay with the royalty-in-kind but went to a privatization in terms of the marketing or handling of it I guess I could say. And you also made the statement that this was done in, in some ways because this was going to maximize returns to the government? Is that—did I—is that correct or——

Mr. HENDERSON. When the government went through the, the process of reviewing all the options, and it is much the same as you are doing now, one of the studies they did and, was a comprehensive price survey amongst all producers in the province. And to appreciate the Alberta, it is very concentrated in one location, and they were able to undertake this study. The study was subsequently verified by an independent consulting firm. What they found is that in applying the models on the cash models to the realizations that the Alberta petroleum marketing was, was getting is that the, the proceeds, the market values the APMC was getting were slightly higher than under the, the models applied under the cash system, and I think that is one of the, the aspects that they looked at thinking well, we are pretty close to be revenue neutral. Why change a fairly efficient system and go through the, the two to three or four or 5 year pain that would probably come in the change of such a massive system when we are revenue or slightly better than revenue neutral now?

Mr. DOOLEY. Um-hum. Ms. Brian, in your testimony, you contend that if we were to go to an RIK type of approach that just the opposite would be what you would expect to happen. And why would that be the case? Why would it be different——

Ms. BRIAN. No, I am not sure I said the opposite would happen. One thing I said is—actually, I did not say that I would like to say now is that while it sounds that in Canada it really has been a very appropriate system, the, the feasibility study that just was released by MMS shows there are some significant differences between what happens in Canada and what happens in the United States. For example, in Canada, the marketers cannot have any ownership interest in refineries which clearly is not true in the United States. Another point is the Canadian marketers are banned from financial hedging. They only receive a flat fee in Alberta. They only have 5 cents a barrel, so that is—these are elements to their system that are really very different from anything we could imagine happening in the United States.

But I am not, as I said earlier, I am not in principle opposed to RIK. All I am saying is the reason we are looking at changing the system is because there has not been a competition at the wellhead. As, as my colleague from NARO was saying, his, his members were receiving postings which were unacceptable which is what we, as Federal landowners, have also been receiving. And by going to an RIK system, we are not addressing that fact at all. We are simply going to change the subject and continue to be relying on this posted——

Mr. DOOLEY. Now were they not—when they discarded accepting the proposal that used basically a benchmark and brought it back with some of the, putting in some reductions for different factors, were they not in effect evaluating what you are suggesting, and they made the determination that this was not going to be as effective in terms of maximizing government returns and also giving the most accurate reflection of what actual prices are?

Ms. BRIAN. I, I do not, I do not quite understand. Who rejected——

Mr. DOOLEY. I thought in Canada you I think basically made the statement that you looked at posted prices and reference prices that would be adjusted, and I would—what I would—my extrapolation is that an—or a NYMEX or an ANS is a reference price that we are talking about adjusting back, and it appears that that is one of the programs that was basically considered and then decided that the RIK program was going to be better in, in Canada. And Mr. Henderson, is that——

Mr. HENDERSON. Yes, that is correct. The, the benchmark reference prices they were looking at were Canadian posting and, and a NYMEX-type price. The adjustment I was referring to would have been an adjustment done by a survey of producer prices and adjusted for not arm's-length transactions, those type of transaction, exchange transactions, etc. The, the survey prices would then come up with an average. The benchmarks would have then have been adjusted by that, that adjustment.

Mr. DOOLEY. I guess the other issue is, and, Ms. Brian, you made a statement that if we, we went to the, the royalty-in-kind is that you would see the marketer capturing the what you would, what you would expect to be the difference between the posted price and, and the market price which you would——

Ms. BRIAN. Or some part of that. I mean you expect them to——

Mr. DOOLEY. You would contend they would be different. But if you had a situation which would, I would expect if we put in place any type of RIK system that allowed for, you know, the competition or even the bidding on the oil that the government would, would be receiving as royalty, why should we not expect the competitive pressures of the marketplace to diminish any excessive returns to the marketer?

Ms. BRIAN. Because the, the implementation of an RIK system would not in any way increase the competition at the wellhead. It is, it is just not addressing that issue. We are not getting more people suddenly with pipelines arriving at the Federal land saying we all want to buy the Federal crude, and we are going to increase the posting in order to, because we really want your crude. That—it just is not addressing that issue.

Mr. DOOLEY. And that is where I guess we go back to, you know, the concern that I had that I think that the MMS proposal, the new proposal is addressed is that you are in effect, if you make that argument, you are then acknowledging that in some respects the posted price is different than the market price or the NYMEX price——

Ms. BRIAN. Right.

Mr. DOOLEY. [continuing] and that is where the, the fundamental issue here is how do we ensure that there is equity in terms of the royalty that is being paid, and that royalty should be a function of what people are receiving. And I guess I am not sure you can have the argument both ways. You know, there is a problem there, if we have an imperfect market, you know, maybe there are some reasons for that. But I mean the whole oil industry is, is somewhat of an imperfect market. NYMEX, what happens, you know, when OPEC meets and they, they make a, you know, a decision which is basically a function of an imperfect market there. NYMEX jumps or goes down. That is a function of an imperfect market too, and I guess my concern is is what we are trying to ensure is that for the oil that is, that we have a royalty that is due that it is fair compensation to the government based on the price that is actually received. And that is where I, you know, I am struggling with, you know, if it is not a royalty-in-kind which would be a direct function of what we would hope that that oil, the value of that oil would have where it is at, you know, how could we get any better than that, I guess? How could we get anything that is any, any more responsive to what the real valuation in this particular location?

Ms. BRIAN. If you will indulge me for a second, I have, for example, a chart that shows Exxon's interfield postings where you see East Texas, Hawkins, and their prices are down here. These are fields where Exxon does not own the land. They have to pay royalties on it. The postings are pretty low when you compare them here to West Texas Sour and, and Yates which is primarily—and the irony here is that, in fact, East Texas is closer to the refinery. So if you look at what the market should have, what should have happened if this were a competitive market is that these prices should have actually been higher, because they are worth more with lower transportation costs. But this is an example of what we are not addressing if we go to RIK. This is going to continue to be happening.

Mr. DOOLEY. Um-hum. And I would be interested in getting some more of the details of that. I am not familiar with that, that situation.

Ms. BRIAN. Sure. I am happy to submit this for the record.

Mr. DOOLEY. Thank you.

[The information referred to may be found at end of hearing.]

Mr. SMITH. Could I just ask one question on that? I—my recollection—I have not looked at this in a long time. But I thought Hawkins was a much lower gravity field, and so you would expect a different kind of price relation——

Ms. BRIAN. It is actually not much lower. There is only about a .2 difference. And so you can see, actually, if you really want to know what is—what is really interesting is is you can see when the Texas suits were filed when suddenly the postings started going up almost to the day in, in 1995. Suddenly, the postings started rising and, and started to mirror the spot prices. And what I understand is that differential, which is relatively small, really is what reflects the quality differential. But these enormous differences could not possibly be answered by that.

Mrs. CUBIN. Thank you. And I do apologize again for having missed the first part of the hearing when the most of you testified. I did read your testimony, and so I have an idea where we are coming from. I want to say there was, there was some testimony that was somewhat inflammatory to me. It, it got my ire up, and particularly some from you, Ms. Brian. I was raised in oil patch. I represent all of those people that work in the oil and gas industry, and all of those people that receive services from the state government and all of those people that provide services by the state government and all of those people that work in the state. I do not represent oil companies or gas companies, and so any, any implication at all or any insinuation that my main goal is not maximizing the amount of money that goes into the state treasury and the Federal treasury is just simply unfair, and it is wrong. Wyoming, as you know, receives more Federal mineral royalties than the next three or four states put together. And I am committed to a system that collects every single penny that is due to the Federal Government and the state government but not one penny more. And——

Ms. BRIAN. I want to apologize if you misunderstood my point, and I think that we are really on the same side. I had no, in no way meant to suggest that you did not want to get everything for the, the landowners and the people who work in Wyoming.

Mrs. CUBIN. That is good, and certainly that is the intention of the entire subcommittee. We want a program, whether it is NYMEX or the program that MMS is proposing or whether it is royalty-in-kind, we want the best program that there is. And I look—I think about the fact that Americans put a man on the moon. Americans have better health care than anybody in the world. I do not think this could possibly be—I realize it is complicated. But I do not think putting an RIK program in place could possibly be so complicated that we cannot figure out how to do it and how to do it fairly to all the parties involved.

And certainly, there are problems, and it is so complicated that we want to do it right and, and possibly a pilot program in a certain area is the thing to do. But, but I think minds that are more knowledgeable in this area than mine need to, need to make those recommendations.

I want to start off by talking to—asking Mr. Smith, could you expand for me how an RIK program might score?

Mr. SMITH. It, I guess, first of all depends on whether MMS implements an RIK program along their recommendation, the line of their recommendations or whether the committee takes action to implement an RIK program. If MMS goes along with its existing recommendations and implements a program, it does not score. That is, it is not the result of Congressional action. Instead, it is the result of powers that the agency has to use today. And so it does not create a scorekeeping issue.

On the other hand, if, if the committee enacts legislation that requires MMS to undertake certain actions that it would not take absent legislation, then it will score. Whether it scores positive or negative is, is again a function of the design of the legislation. And so at that point, I think you get into the case where the details matter greatly. So again, I think that the committee can come up with something that is scorable and can be revenue neutral, but it does require legislation in order for scorekeeping to become an issue.

Mrs. CUBIN. Could you give me some, some more background on the implications of mandatory versus a voluntary program? Do you have any thoughts on that?

Mr. SMITH. Sure. I mean if, if we have a—well, let us split voluntary into two pieces, and let us assume this is in the context of legislation, so it does become a scorekeeping exercise. We have a voluntary program where MMS can determine which properties it chooses to take and which properties it does not choose to take. I believe that would be consistent with their authority under current law, and so it then would have no score. CBO would, would not score it.

Now one of the implications of that is if you should do that in the context of something like a budget reconciliation bill, the provision could be knocked out under the Byrd rule over in the Senate, and the House gets very concerned about that, but nevertheless, the Byrd rule is very effective in killing legislation where the committee is doing something again that the Agency can do already. So I think there is a problem there.

On the other hand, if we have a program that is voluntary from the lessee side, then the lessees can in effect cherry pick which kinds of properties they want as part of the program, and that will trigger a revenue loss. So the only way of getting around this, I think, is to have a mandatory program where MMS is required to implement the, the program and to design it in such a way that, in fact, it will be revenue neutral. At that point, you have got a workable program. I think a voluntary program just will not accomplish anything that you can, can honestly work with.

Mrs. CUBIN. Thank you. Mr. Rorschach, I know that you have to leave at 4:20 and it is 4:20. I have one more question, because I have the yellow light, and I will be going on into the red. I am going to talk to Mr. Neufeld here, but I will be submitting questions in writing if you would not mind responding—if all of you would not mind responding to those. So if you need to excuse yourself, that is fine.

Mr. RORSCHACH. I, I would like to make one comment. I do not know whether this is particularly germane to the subject, but I heard many questions asked about why, why we cannot just use the market to determine the market, and I have heard comments saying well, there is only one pipeline into the lease, and therefore that—well, these people are looking at different leases than I have looked at, because most of the leases I have seen, there is no pipeline in there at all. The truck comes in and picks up the oil. And I am telling you, there are lots of trucks around. There are lots of people who own trucks who are, who are willing to come pick up that oil and, and how it happens is the pumper calls the, the trucker and says look, come on out. We got a tank full of oil. And the trucker comes out, and the pumper straps out the tank and, and off it goes and he leaves him a run ticket. Now there is no pipeline involved there, and the market can certainly handle that.

Mrs. CUBIN. Thank you.

Mr. RORSCHACH. Thank you.

Mrs. CUBIN. Mr. Neufeld, I will be asking this same question of Mr. Brown with the MMS, but I want you to, since you are up, seems to me that the producers are the ones that are liable for paying the royalty. Why in this case is the refiner being charged with the royalty retroactively? Do you——

Mr. NEUFELD. I, I believe——

Mrs. CUBIN. [continuing] what reasons have you been given, or do you understand it? It is beyond me.

Mr. NEUFELD. Yes. The Minerals Management Service points to a provision in our contract that says that the price of the oil that we are charged will be determined under 30 C.F.R. which is a large section of the Code of Federal Regulations. Our understanding and,

and we believe based on, on memos that were written to us by MMS, and this is getting into the legal aspects, and I do not want to try the case here. But our understanding of that provision is that MMS would take the benchmarks in the rules, apply them to their oil and reflect that in our invoice. Their interpretation is: no, that was not the case. When we said that we agreed to have the oil priced under 30 C.F.R., we agreed that when they went back and audited the producers, after the fact, that we would be bound by those proceedings and agreed to have our prices adjusted accordingly. And so it is a difference in interpretation over that section of the contract.

Mrs. CUBIN. Well, thank you very much all of you for being here today. I know it has been a long time, but we do appreciate your coming. It is very important to the process, and so if you would like to take your leave, that is fine.

Now I would like to call Mr. Brown from the MMS to please come forward to testify. Thank you very much, Mr. Brown, for being here. We have a vote coming up maybe in about 20 minutes, and so I think if we all stick to the 5-minutes that we are allotted, we will have just about the right amount of time, and then we can adjourn this hearing, and everyone can be off on their way. So if you would like to present your testimony.

STATEMENT OF ROBERT E. BROWN, ASSOCIATE DIRECTOR, MINERALS MANAGEMENT SERVICE, U.S. DEPARTMENT OF THE INTERIOR

Mr. BROWN. Thank you, Madam Chairman, members of the subcommittee. I appreciate the opportunity to appear today to present testimony on the Mineral Management Service's examination and implementation of programs to take oil and gas royalties-in-kind. We at MMS are excited to be discussing these issues. It appears to us from our recently completed royalty-in-kind feasibility study that the exercise of Federal lease rights to take Federal oil and gas production share in-kind may offer opportunities to both dramatically streamline the royalty management process and at the same time enhance mineral receipts, if we deliberately and intelligently design and implement RIK programs where appropriate.

Today I will describe our future plans in this area, but first I would like to briefly discuss the major results of our feasibility study. I ask that my prepared testimony be entered into the record.

Our final report on the royalty feasibility study was issued just about a month ago, and the feasibility study was taken as one of a series of MMS initiatives to examine how we can improve our royalty management processes through innovation. Additionally, we had reported language from the Congress in the last session recommending that we undertake studies of the feasibility of royalty-in-kind programs. The final report is available on our home page at www.mms.gov.

The primary objective was to determine if RIK programs are in the best interest of the United States, meaning if they, one, offer potential revenue enhancement or neutrality for the Federal treasury, and two, provide extensive administrative relief for MMS and for industry.

We concluded that RIK programs, if implemented under favorable conditions, could be workable, revenue neutral or positive and administratively more efficient for MMS and for industry. What are favorable circumstances? Well, we would participate, particularly in, in gas and downstream marketing and sales, and particularly again for gas that aggregation would provide supply assurance which would provide market opportunities for the Federal production, and administrative relief both for us and for the producers. Less reporting, less auditing for all parties.

Now unfavorable conditions which could lead to the program not being successful we think should be avoided are if we continue to audit the producers' shares of production. Second, if we required MMS to take in-kind everywhere or at the lessee's discretion. Third, if we had to pay above-market transportation rates where we encounter nonjurisdictional lines. Fourth, if we had to accept RIK volumes that were at less than marketable condition, and fifth, RIK on scattered, onshore basins with minimis volumes.

The report recommends three in-kind pilots. The first is a royalty marketing program for the Gulf of Mexico involving natural gas which we believe would have a high chance of success if it involved substantial volumes and ran for at least 3, if not 5 years and was contractually performed by an energy marketer and provided for MMS to share in downstream proceeds realized. Although actual revenue returns will depend on specific proposals from energy marketers, we believe that royalty revenues will increase due to increased aggregation of downstream market.

Thus, the report recommends pursuing a long-term RIK program in the Gulf of Mexico in which substantial volumes of natural gas would be marketed and sold by an energy marketer under contract with MMS. We stress that before decisions are made to implement this program, we need to do detailed economic studies and make certain that that leading proposal would, in fact, be revenue neutral. Implementation would occur if all indications are positive.

The second recommendation of the report concerns crude oil in-kind programs. We had workshops and meetings with energy marketers which did not produce any clear evidence of revenue enhancements or, for that matter, in some cases revenue neutrality from crude oil RIK. But based on our research, we believe that the revenue implications continue to be uncertain for oil RIK. Consequently, we do not endorse widespread implementation. However, considering the significant interest on the part of producers, marketers, and the State of Wyoming, the report concluded that a small-scale program for crude oil RIK could be jointly pursued by MMS in that state. Similarly, the report notes that the State of Texas has interest in RIK, and as a result, the third recommendation calls for a joint exploration of options with the state for both 8(g) leases and Federal offshore leases for oil or gas.

Regarding future activities, our senior management team at MMS has accepted the report and its recommendations. Within the next month, we will begin our implementation of the report's recommendations. Our first course is to consult with Congress, which we have done with staff and we are doing here today, and consult with the states. We sent a formal invitation to Governor Geringer of Wyoming and to Commissioner Mauro of Texas to form teams to begin implementation. Governor Geringer has responded positively and will begin meeting with members of his staff in the near future to begin implementation of the pilot.

We will meet with industry. We have meetings set for next week, both the 22nd in Washington and the 24th in Denver, to followup on the report and discuss the implementation. And then finally, inreach within our own program explaining to the royalty program employees and to the offshore program how these programs will work.

We will soon form an implementation team to pursue the report's recommendations. The team will identify the scope and overall framework of the offshore gas in-kind program and will work with Texas and Wyoming to do the same for the other pilot. We would like to work with industry in developing program details.

I would like to reiterate that before actual implementation of any program, we will conduct detailed economic analysis necessary to determine chances for a program's success. As stewards of a public asset, our responsibilities are first and foremost to ensure that the public's assets are wisely managed.

In closing, I would like to express our cautious optimism that in-kind programs may provide us with a great opportunity to resolve a difficult area of public lands management in the manner that could provide substantial benefits for the regulated industry, MMS, and most importantly, the American taxpayer.

Madam Chairman, this concludes my prepared remarks, and I would be pleased to answer any questions your or members of the subcommittee may have.

[The prepared statement of Mr. Brown may be found at end of hearing.]

Mrs. CUBIN. Thank you for your testimony. Mr. Thornberry, would you like to begin the questioning?

Mr. THORNBERRY. Yes, ma'am. Thank you.

Mr. Brown, were you here through all the prior testimony?

Mr. BROWN. Yes, sir.

Mr. THORNBERRY. OK. A couple of points seemed to me that we had pretty much universal agreement on. No. 1 is that, that the current system is a mess. The second one is that pretty much everybody agreed, in principle at least, that royalty-in-kind makes some sense. Would you concur that that is kind of a summary of where we are generally among people who are interested in this issue?

Mr. BROWN. I think that is fair representation of what the people in the panel had to say. Some are more cautious about RIK than others.

Mr. THORNBERRY. Sure. But I have not heard, and this is the second hearing we have had within a couple months, I have not had any, heard anybody stand up and defend the current system, and I have not heard anybody say that under no circumstances would royalty-in-kind make sense. And so what, what that leads me to think is now it is a question of working out the details of how it is going to work. And I understand that that is, that is an important challenge, and we got to get it right.

I guess what I am really curious about is what is the commitment of MMS to sit down with industry folks, others that are interested, to work on these details regardless of whether you all think it needs to be mandatory or whether Congress ought to impose it nationally or how. But, but what is your commitment to sit down and work on transportation issues and these, these other things?

Mr. BROWN. Well, I think in regard to the pilots, our commitment is to sit down and, do that immediately. As Director Quarterman testified in July, we will be happy to sit down and look at legislative proposals. We are not going to mandate that we or commit to agreeing to them, but we would be happy to discuss them.

Mr. THORNBERRY. Are you all going to have a legislative proposal that you are going to send up here for us to look at?

Mr. BROWN. Well, sir, we do not believe that we need legislation to carry forward on these programs, and we believe that carrying out these cautious pilots should be able to give us indications that would lead later to legislative relief if necessary.

Mr. THORNBERRY. I understand that, and I understand that, that you do not want to commit to supporting something, but you are willing to sit down in the meetings next week and, and otherwise to work through some of these details with industry and talk about how it could work if we were to do something like that.

Mr. BROWN. Certainly.

Mr. THORNBERRY. OK. Do you have any idea how many disputes MMS is currently involved in now relating to the amount of Federal royalty owed, whether they are lawsuits or administrative claims of some sort?

Mr. BROWN. Well, one of my areas of responsibility is processing the administrative appeals, and we have a docket of some 600, 700 active appeals. As you remember in the last session, the Congress passed legislation, the Royalty Simplification and Fairness Act, which requires us to complete the docketing of those cases in 36 months. We had substantial backlogs in the previous period. We are effectively moving to eliminate those. But that would not capture all of the disputes. There are other disputes that are farther along with the bureau. The Interior Board of Land Appeals, and additionally there is litigation, so I could not give you a specific number.

Mr. THORNBERRY. OK. Let me ask this. One, one of the issues that has been discussed is transportation issues, particularly for offshore where you have pipelines. As I understand the way it works now, royalties are based on a price, and then there is a deduction for transportation costs through the pipeline to get it onshore.

Mr. BROWN. Correct.

Mr. THORNBERRY. And it is also my understanding that MMS pretty much sets the amount of that deduction.

Mr. BROWN. Well, what occurs on offshore, the pipelines are not covered by FERC tariffs, so the actual calculation is done on a calculation of the amortized cost of the production of the pipeline. So there is an audited price.

Mr. THORNBERRY. OK. Do you have any idea what the relationship is between that calculated price and the market price for some other company that comes and tries to use that pipeline to bring their crude say onto shore?

Mr. BROWN. Well, in this case it is a nonjurisdictional pipeline that is privately owned, and well, we would let them deduct their actual costs for those firms. In other words, if another firm uses that——

Mr. THORNBERRY. So——

Mr. BROWN. If another firm uses that pipeline, that firm would deduct its actual cost, because it had engaged in an arm's-length agreement to transportation. It is only in the case of someone who owns the pipeline and would essentially be setting the price for themselves that we do that calculating.

Mr. THORNBERRY. And do you know what, if one oil company say wants to use a owned pipeline, you set the cost for the government to be reduced from the government's share. Do you know what the relationship is between the market price and that generally and what the price that you all set——

Mr. BROWN. I would, I would.

Mr. THORNBERRY. My understanding is it is lower, and I, I wonder if you, if you——

Mr. BROWN. If the market price is lower than what we calculate——

Mr. THORNBERRY. That you are, that you are lower.

Mr. BROWN. We may very well be. But that is where we are talking about amortizing their costs, and then they have to make a profit when they are selling that transportation to someone else. So in the first case, it is derived simply from their cost, and in the second case, they are deriving a profit over and above their costs.

Mrs. CUBIN. Everyone agrees that if we have, in order to measure the success of an RIK program, we have to know the costs that MMS currently incurs in enforcing what we have right now. When Director Quarterman was in front of the committee in July, I asked her for a summary of the Federal Government's cumulative cost on, associated with audit and enforcement of royalty obligations including, but not limited to, other Department of the Interior costs such as workload at the Office of Hearings and Appeals and the Justice Department resources spent in litigation. We have not received that information yet. Would you have any idea when we will?

Mr. BROWN. I will make certain you get it as soon as possible, Madam Chairman. I regret that we have not provided that yet.

[The information referred to follows:]

Questions from Chairman Cubin

1. **In questions posed to MMS following the July 31, 1997 R-I-K hearing, I asked for a summary of the Federal Government's cumulative costs associated with audit and enforcement of royalty obligations, including other Department of the Interior costs, such as the workload at the Office of Hearings and Appeals, and Justice Department resources spent in litigation on these issues. MMS did not provide this estimate, that I can see, in any of the follow-up answers received September 17, 1997. The Subcommittee would like to have this information in order to get a better handle on the real costs government-wide associated with the current valuation system.**

The Department's costs for audit and enforcement of royalty obligations total approximately $28 million for fiscal year 1997. This includes Royalty Management Program audit and enforcement costs of about $26 million, Interior Board of Land Appeals costs of $150 thousand, Office of the Solicitor costs of $400 thousand, and MMS Appeals Division costs of $1.3 million. As you may know, litigation on behalf of the Department of the Interior is handled by the Department of Justice. We are not in a position to provide the Department of Justice costs associated with litigating the issues. It is our understanding, however, that the Department of Justice does not routinely calculate the costs of individual cases, and therefore does not keep records in the form you request.

We caution that even under the best-designed R-I-K program not all litigation costs would disappear. Litigation cost savings would depend on the type and scope of oil or gas R-I-K programs implemented, and litigation costs would continue for Indian, solid, and geothermal minerals that are not taken in kind. Further, expected reductions in auditing costs would be deferred for at least 6 years as auditors complete reviews of prior periods.

Mrs. CUBIN. Because certainly that is very important for us to, to know before we proceed.

Mr. BROWN. It is, in some cases, difficult for us to derive what the Justice Department spends. But we, we should be able to give you a calculated cost.

Mrs. CUBIN. An educated estimate at any rate. CRS did a report on the Alberta RIK program in relation to potentially one in the United States, and it said that there were two factors that seemed to contribute to the Alberta RIK programs that, that have caused it to be successful, that is large oil volumes and low-cost transportation. And one thing I wanted to know is do you think that the pilot project in Wyoming will be a true indicator of whether or not an RIK program nationally will be successful?

Mr. BROWN. Well, that is a two-stage question, Madam Chairman, if I could first address the Alberta situation. As we understand the province of Alberta, the—we have large concentrations of, of volume, of production with limited refining capability. That is, that there is less refining capability in the province than there is production. And so that crude has to seek a market somewhere else, and it seeks the market in the, in Chicago and in Ontario and others—much of what the marketer does—the uplift that the marketers are achieving they are achieving through moving that crude to those markets.

In Wyoming, there is a certain similarity in that there is limited refining capability for the production in Wyoming, and there is only certain places that one can take that, and perhaps by marketing that crude beyond those refineries and by aggregating the volumes, we can achieve the same kind of results as have been achieved in Alberta. The state of Wyoming is very sanguine about the possibility of that result, and we are a little skeptical, but we are willing to attempt to make certain that we do everything to make it work.

Mrs. CUBIN. Well, the reason I asked that question is because if we really wanted to try to draw some sort of similarity to the Alberta experience, the Alberta province is approximately 255,000 square miles with a pipeline infrastructure that reaches to all of the corners of the province. This is just less than the total square miles in Wyoming, Utah and Idaho combined and less than the Gulf of Mexico. So why not expand the, the pilot program if——

Mr. BROWN. Well, because of the interest of the state we have chosen Wyoming. As you pointed out earlier to the earlier panel, the onshore states derive significant incomes from production on oil, of oil and gas on, on Federal lands. The State of Wyoming is interested in RIK and has expressed an interest, so many of the other states have expressed no interest or have, have said that they are not, they are opposed to such a program. We did not think that we could go forward with an RIK program that, that potentially had some risk without the concurrence of the state who is deriving revenue from that production. So the Wyoming's interest is primarily the reason why we are moving forward in the Wyoming area.

Mrs. CUBIN. But you——

Mr. BROWN. In addressing the second question, in the Gulf of Mexico, there is substantially more refining capability in Louisiana and Texas than there is production in the, from the Gulf of Mexico. There is gas, oil being brought—excuse me, oil being brought in from overseas through—and through Houston and Corpus Christi to be refined there so that we do not have the same—it is the reverse of the circumstance in Alberta where you have large volumes of crude production with limited refining capability, and the, in the Gulf of Mexico, you have, you have more refining capability than you have production.

Mrs. CUBIN. In the followup question that was submitted by Representative Romero-Barceló after the July 31st hearing, you outlined plans for the MMS to proceed on RIK, and specifically, you mentioned preparing detailed requirements, program strategies and, and analysis of impacts. We have not seen that yet either. Do you have any idea when that will be complete?

Mr. BROWN. We have not completed it yet. Now that is the next stage right now. What we have done is complete the feasibility report, and the next thing we have to do is develop implementation plans. And, and part of our, the recommendation in the report is that, that we would be using a different approach than we did at our previous pilot which we specified very clearly the how, how the marketer, where, where they were to take the production, which was at the lease, and, and what they were to do with it. Very specified classic government kind of contract.

What we are proposing to do here is take a different approach and say that we would make available to qualified energy marketers the specifics of what production we intend to take and ask them to give us a business case solution for how they would market that gas and, and how we would share in the profits that were derived from that marketing. And the one that gives us the best business case and the largest result would be the marketer that got the contract. So that would require—our analysis will have to go forward until we actually get to the point of receiving bids from these folks to really know what the results would be.

Mrs. CUBIN. One last question. While I, I am pleased that Wyoming will be used as a pilot or a test on this issue, I still cannot help but be concerned that, that the results of the pilot program really may not be a good reflection of what might happen nationally. If in fact the program in Wyoming turned out not to be profitable for the government because we do not—I am not aware of the major lawsuits, at any rate, like have gone on in California, and certainly those costs would not be in the Wyoming model, and the, the volume of oil that Alberta is dealing with would not be in the model, and we all agree that larger volumes give a better profit. So are—do you think that absent legislation that MMS would use a not real successful program in Wyoming to decline any action moving forward on RIK?

Mr. BROWN. Well, I would have to assume that it would depend on the reasons why it was not successful. Clearly, if it was unsuccessful because of peculiarities of the market that we did not anticipate, that should not be a reason why we would not go forward with RIK. It might not be unlike the circumstances of our 1995 pilot where clearly, we did not understand the way in which the market operated. We created a pilot that as one of, I believe Mr. Thornberry said was really an absolute wrong way to conduct a pilot. We would not do it again. And if we—if that was the reason why we were unsuccessful, then certainly that should not be a bar for us moving forward. If the reason we were unsuccessful was peculiarities of the Wyoming market, then again, I do not think that would necessarily be a bar to moving forward with the in-kind programs.

Mrs. CUBIN. Well, thank you very much. I do appreciate the testimony. It has been very valuable. We will keep the record open for 10 days if there are additional comments. And if there is no further business, then this Subcommittee is adjourned.

[Memorandum from Mr. Condit may be found at end of hearing.]

[Memoranda from Mr. Humphries may be found at end of hearing.]

[Statement of Mr. DiBona may be found at end of hearing.]

[Whereupon, at 4:47 p.m., the Subcommittee was adjourned.]

[Additional material submitted for the record follows.]

PREPARED STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE, SUBMITTED BY CHARLES DIBONA

The American Petroleum Institute (API) is a trade association with over 350 members engaged in all aspects of the petroleum industry. API respectfully submits this statement of its views for the record on the Royalty-in-Kind issue for oil and gas valuation.

The American Petroleum Institute supports the development of a Royalty-in-Kind (RIK) program as an alternative to the present royalty valuation rules for crude oil and natural gas production from Federal leases, and to the Minerals Management Service (MMS) proposed rule for the valuation of crude oil production. Properly crafted, an RIK program would reduce valuation uncertainty and would also reduce administrative costs to both government and oil and gas producers. Also, an RIK program can be revenue neutral, while reducing government administrative costs, thereby yielding a net increase in revenues to the government.

In 1988, the MMS adopted its current regulations governing royalty payments for oil and gas produced on Federal leases. Under this rule, oil and gas royalties are based on the value of production which is measured by either the gross proceeds accrued to the lessee, or benchmarks such as posted prices. The MMS audits the valuation estimates submitted by the companies and challenges estimates when the agency believes errors have been made. This process has been characterized by numerous and costly disputes, both for the MMS and for the companies that must document and defend their valuation estimates. This is why both the companies and MMS have concluded that the current royalty system has many problems, and should be changed.

An alternative to the present royalty valuation system is an RIK program in which the government takes its royalties “in kind” (in physical units) and sells its royalties in the open market. In 1995, MMS conducted a pilot RIK program for natural gas production in the Gulf of Mexico. The aim of the program was to test an RIK program operationally and to determine its impact on Federal revenues. MMS concluded initially that the program appeared to reduce revenue, but API and others have indicated that MMS’ analysis was incomplete and inconclusive.

In January 1997, MMS proposed a new valuation rule for crude oil. Among other things, this proposed rule would scrap the existing rule’s reliance on benchmarks, such as posted prices, for valuing production in non-arm’s length transactions. In its place, lessees would be required to use an index valuation scheme involving New York Mercantile Exchange (“NYMEX”) or Alaska North Slope (“ANS”) prices adjusted for locations and product quality. API responded to this proposed rulemaking in detail, identifying several serious flaws. API also stated that the MMS should fully explore royalty-in-kind as an alternative to the proposed index-based scheme.

Since both the existing royalty valuation rules and the MMS-proposed alternative are problematic, many lessees have come to view RIK as an alternative. Accordingly, in Spring 1997, API joined with several industry trade associations to form an RIK Workgroup to determine if the industry could develop a workable RIK program. Joining API in this effort were several other industry associations, including the Independent Petroleum Association of America (IPAA), the Domestic Petroleum Council (DPC), the Mid-Continent Oil and Gas Association (MCOGA), the National Ocean Industries Association (NOIA), and a number of state and regional organizations. The Workgroup developed six basic principles that all members, including API, agreed should govern any RIK program. API supports these principles, as key components of any RIK program.

The first principle calls for the reduction of administrative and compliance burdens while providing the opportunity for Federal and state governments to maximize their respective revenues. The MMS should have the ability to optimize value by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. The potential for increased revenues would require the MMS to manage the risks and incur the costs associated with marketing royalty oil and gas. Federal lessees should not see any increase in administrative costs or experience operational burden. Federal lessees should have certainty through elimination of disputes associated with royalty valuation. Similar benefits will accrue to the government. Also, lessees should not have any costs or obligations beyond the lessee’s obligation to deliver at, or near the lease. Reporting should be related to volumes produced and delivered, not sales prices or other related valuation information. Finally, marketers should be provided a business opportunity which has an acceptable risk/revenue ratio, thereby enticing participation by the most professional and successful marketers in the business.

The second principle requires transactions at, or near, the lease to fulfill the lease obligations. Once the production is delivered at an RIK delivery point at, or near, the lease, the lessee's royalty obligation must be completely satisfied. A lessee must have no duty to market or transport the government's oil or gas past this point. All risks and costs incurred downstream of the RIK delivery point should be borne by the lessor or its purchaser, in the hope of realizing maximum revenue from reselling the production downstream. An effective RIK program should not hold the purchaser liable for the lessee's failure to perform under the lease contract.

The third principle provides that when the government elects to take "in kind," it must take all royalty production for a time certain. Further, if the government takes its royalties "in kind," it must give sufficient notice and, for a time certain, take the full royalty fraction tendered by the lessee(s) from a given property. The government must have no right under the lease to defer its take obligation, or leave its production in the ground. Moreover, the government must have no right under the lease to defer any production from either new or existing leases. Otherwise, lessees will be unduly burdened by additional marketing and operational problems.

The fourth principle requires the use of private marketing expertise to streamline government operations. The government's oil or gas should be marketed through a competitive, privatized system in order to maximize benefits, and streamline government operations.

The fifth principle provides that the states should have the opportunity to be involved with designing and implementing the program. At least one state, Wyoming, has been actively promoting royalty-in-kind concepts this year. In addition to being actively involved in the design of a government RIK program, the states need to be given the opportunity to participate in the marketing of the Federal royalty stream taken "in kind."

The sixth and final principle makes royalties taken "in kind" broadly available for public purchase. Any production subject to this royalty-in-kind program should be made available on an open, competitive basis to a broad-based public market. This would include providing the opportunity to market to a broad group of interested and qualified marketers.

If an RIK program for oil and gas were to be implemented based on the above principles, MMS would benefit in several ways. First, MMS would have the opportunity to maximize the value of its oil and gas. Second, an RIK program would eliminate many of the complexities and uncertainties surrounding valuation of product at the lease. When royalty is taken "in kind" rather than in value, the market value is basically the price the MMS receives in the marketplace from a willing buyer. Finally, the administrative burdens for both MMS and the Federal lessees, particularly audit, record keeping and litigation costs, would be sharply reduced.

Finally, API supports the MMS's efforts to move forward with an examination of potential RIK programs, as described in its *Royalty in Kind Feasibility Study* (August 1997), released September 2, 1997. API urges MMS to look closely at the workability of an RIK program for crude oil as well as for natural gas production. Such a program could accomplish the goals stated by MMS Director Cynthia Quarterman last week when she noted the potential for RIK programs to "both streamline the royalty reporting and auditing process and to enhance revenues to the U.S. Treasury." API also fully supports the decision by MMS to seek additional input on alternatives to crude oil valuation before proceeding further with the oil valuation rulemaking.

BRIEFING PAPER ON
ROYALTY-IN-KIND FOR FEDERAL OIL AND GAS PRODUCTION

ISSUE

On federal lands, including the outer continental shelf (OCS), lessees make a cash payment for a portion of their production value (usually 1/8 onshore, or 1/6 offshore) as a royalty to the federal government. Valuation of production is a complex and burdensome process for lessee and lessor alike that has resulted in years of litigation and the establishment of a large government audit staff. In 1995, the Minerals Management Service (MMS) conducted a pilot program in the Gulf of Mexico for taking the federal government's share of natural gas production "in-kind," as opposed to receiving cash value. In June, 1996, the Subcommittee held a hearing which focused on the lessons learned from that pilot program. Subsequently, in the conference report (104-863) for the FY 1997 Omnibus Appropriations Act (H.R. 3610), Congress asked MMS to pursue additional royalty-in-kind (R-I-K) pilot projects.

This is the first of two oversight hearings, with a follow-up hearing planned for mid-September. The Subcommittee has invited participation from several States, a panel of industry marketers and producers and the MMS. In this first hearing, we will learn more about the current R-I-K programs for oil and gas that the Texas General Land Office conducts on state lands, how the affected industry would evolve under such a program and an update of the MMS' activities since the 1995 pilot. The second hearing will focus on outside witnesses including consultants, think tanks, economists and third party industry experts with a primary focus on the program used by the Alberta provincial government to take the Crown's share of royalty oil in-kind.

BACKGROUND

The MMS is responsible for collecting royalties on approximately 4.3 trillion cubic feet of natural gas produced from the Gulf of Mexico each year, as well as from onshore federal leases, primarily on public domain lands in the western U.S. The Mineral Leasing Act of 1920 (for onshore leases) and the OCS Lands Act of 1953 (for offshore) both give the Secretary of the Interior the discretion to collect royalty in-kind, albeit R-I-K is now the exception, rather than the norm. Currently royalty collection efforts are based on regulations promulgated in 1988 (30 CFR 206), which clarified existing regulations as to arm's-length gross proceeds from a lease. Another change affecting the gas markets were the Federal Energy Regulatory Commission (FERC) orders which in effect deregulated the natural gas industry, transforming the transportation and marketing sectors into the diverse, competitive system we have today.

VALUATION REGULATIONS

Oil valuation regulations (at 30 CFR 208) are currently under review at MMS. Two iterations of draft rulemaking have been published wherein the agency has proposed to base crude oil valuation upon contract prices negotiated in the New York Mercantile Exchange (NYMEX) market, minus certain transportation factors. This represents a radical departure from reliance upon gross proceeds received as the basis for valuation, where so-called posted prices in the field prevailed as a measure of value. The comment period for second iteration of the "NYMEX minus" proposed rule closes on August 3, 1997.

The rationale for MMS' proposals on crude oil valuation appears to be based upon concerns that gross proceeds are difficult to define where true arms-length transactions between producers, marketers, and refiners do not exist because significant volumes are moved within a vertically integrated company's captive parts, i.e., from wellhead to its own refinery. By definition, "independent producers" must sell their crude to either independent refiners or to integrated oil companies with refining capacity and therefore are captive to whatever the local market will bear.

The "NYMEX minus" proposals are viewed skeptically, at best, because MMS has engendered little trust in producers that the size of the transportation deduction before computation of royalty owed would be realistic, resulting in a value consistent with the gross proceeds they can expect to receive in the field in which the production occurs. In other words, the proposed rule(s) appear to creep the point of valuation for royalty purposes downstream from the wellhead or lease boundary toward the end users, which in effect levies a royalty upon the value added from aggregation of volumes and aggressive marketing of those volumes.

THE 1995 ROYALTY-IN-KIND (R-I-K) PILOT

The 1995 gas R-I-K pilot program was a voluntary program conducted in the Gulf of Mexico from January 1, 1995, to January 1, 1996. The MMS had two objectives for the pilot: 1) streamline royalty collections; and 2) test a process which promises increased efficiency and greater certainty in valuation of the product for royalty purposes. Fourteen lessees volunteering 79 leases participated in the pilot committing 6.5% (123.5 million standard cubic feet) of the royalty gas volumes in the Gulf of Mexico. Thirteen marketers were awarded contracts to purchase the royalty gas. None of the leases volunteered for the pilot were within the 3-mile "Sec. 8(g)" zone, the area in which federal royalty revenues are shared with coastal states.

Under the pilot, a lessee made available to an MMS marketer, each month, the federal government's entitled share of production. The MMS took title to its gas at the designated transfer point and simultaneously sold the gas to a purchaser or marketer. The lessees continued to make production decisions, perform gas control activities, and operate any pipelines upstream of the facility measurement point.

GOALS OF AN R-I-K PROGRAM

The main objective of any expanded program would be to maximize federal and state revenues by 1) consolidating the government's royalty volumes thereby creating a marketing advantage for the products; 2) reducing the size of the government bureaucracy to run a royalty program; 3) reduce the administrative costs charged to the states; and 4) greatly diminish the cost of litigation associated with royalty valuation.

The program must be practical, efficient and cost effective to administer by the MMS and to comply with by the industry. In addition, the program must ensure certainty by fulfilling royalty obligations in the transaction at or near the lease, promote simplicity in the royalty management program and capable of change with fluctuating market conditions. The states will play a primary role in designing and implementing legislation to maximize revenue and create a manageable, if not transparent, state/federal interface. The program will utilize private marketing expertise and assure that production taken in-kind is available for public purchase.

CONCLUSION

Conceptually, R-I-K has bipartisan support in Congress and among state regulators, the Administration, and the industry. The complex programmatic details are where the idea becomes more controversial. From this hearing and further interaction with the MMS, the Subcommittee will determine what changes to existing law, if any, are needed to allow States with production in the OCS Lands Act Sec. 8(g) zone to take their fraction (27%) of royalty oil and gas in-kind.

The Subcommittee believes several questions need be answered before crafting legislation to implement a R-I-K program, including:

1. Can a federal R-I-K program reduce administrative costs by eliminating overhead associated with valuation of the product?

2. Can a federal R-I-K program maintain or increase revenue through a marketing advantage of its large volume of royalty oil and gas?

3. Can issues such as delivery point, marketable condition, production fluctuation and volume balancing be resolved so that marketing of the federal product remains competitive?

Attachments:
Witness list
Summary comments from the MMS public hearings held in the spring of 1997

MINERALS MANAGEMENT SERVICE
1997 ROYALTY-IN-KIND FEASIBILITY STUDY

SUMMARY OF PUBLIC COMMENT AT RIK WORKSHOPS
MARCH - MAY, 1997

The Minerals Management Service (MMS) conducted a Royalty Gas Marketing Pilot in 1995 in which it sold Gulf of Mexico royalty gas at the lease to competitively selected gas marketers. Subsequently, Congress directed MMS to consider additional projects for taking oil and/or gas in kind. In response to this directive and MMS' ongoing exploration of potential improvements to the royalty management process, MMS Director Cynthia Quarterman formed the 1997 Royalty-in-Kind (RIK) Feasibility Study. In this study, MMS considered a variety of RIK options built on lessons learned in the 1995 Pilot. These options formed the focus of a series of public workshop meetings held by MMS in March, April, and May of 1997 to obtain public comment so that MMS could become better informed of the issues surrounding RIK programs. This document summarizes the public comment at these meetings.

I. NATURAL GAS WORKSHOPS - OUTER CONTINENTAL SHELF

Four options - ranging from conservative to aggressive in approach - were developed to reflect a spectrum of possible RIK programs for natural gas. Each of the options addressed Outer Continental Shelf (OCS) leases in the Gulf of Mexico.

- Option 1: Enhancement of 1995 Pilot. MMS takes its gas at the lease and competitively sells it to the highest bidder, reserving the right to reject all bids.

- Option 2: Focused MMS Gas Marketing. MMS takes all royalty gas from several pipeline systems at the lease or onshore, aggregates, markets, and sells by competitive bid, with the assistance of a marketing consultant.

- Option 3: Widespread MMS Gas Marketing. MMS takes some gas from most pipelines at the lease or onshore, aggregates, markets, and sells by competitive bid, with the assistance of a marketing consultant.

- Option 4: Private Sector Marketing of U.S. Gas. MMS takes all royalty gas from many pipelines, and retains one or several marketers to arrange for transportation, aggregation, marketing, and sales on a service basis.

The MMS study team held public meetings/workshops on March 19, 1997, in Houston, Texas, and April 2, 1997 in New Orleans, Louisiana, to discuss and obtain input on the RIK options and associated issues involved in Federal RIK programs for natural gas on the OCS. The meetings were announced in the Federal Register (FR 97-4350) on February 21, 1997. The following summarizes comments on MMS gas RIK options made during the public workshops.

General Comments

The general consensus of participants at the workshops was that they were in favor of MMS taking its gas royalties in kind under either Option 1 or 4, subject to the comments below.

Proposed Regulations

The producing side of the industry would like to be involved in any rulemaking that may precede implementation of an RIK program. Specifically, the Independent Petroleum Association of America (IPAA) offered to assist with regulations if MMS commits to pursuing RIK. Also, IPAA would like to work with MMS to pursue a legislative change to the Outer Continental Shelf Lands Act (OCSLA) changing the fair market value definition (similar to a proposed change that was in the original draft of the *Federal Oil and Gas Royalty Simplification and Fairness Act of 1996)*.

The producers would like any new regulations to be simple and flexible. They also do not want additional burdens placed on them by the regulations, such as requirements for arranging transportation for U.S. gas or for reporting additional data. Lastly, producers cautioned against the government creating a "non-level playing field" through promulgating self-serving regulations for the transportation of RIK gas.

MMS Marketing of Gas

Attendees did not express any concerns about MMS competing in the marketplace if MMS takes royalty gas at the lease and either sells to a marketer or retains an agent to market for the government. However, there were some concerns expressed over intrusive government if MMS were to get involved in downstream marketing.

All parties agreed that MMS should seriously consider utilizing private sector marketing expertise to potentially enhance revenues. The attendees further stated that this approach would actually reflect a less intrusive government due to letting the marketplace work rather than having the government second-guessing industry's marketing and sales decisions.

Mandatory Participation, Lease Selection, Aggregation, Contract Terms

Attendees were not opposed to MMS taking its production in kind on a mandatory basis, recognizing MMS' authority under lease terms to take royalties in kind. However, lessees stated their opposition to any attempt by MMS to select only those leases where it appears that the government would realize revenue enhancement. Rather, they would prefer that MMS take production from all leases in a given system or area, and take 100 percent of production from these leases. All parties agreed that an RIK program should involve all working interests on a lease and all leases in pooling agreements.
The marketers in attendance would like to see MMS aggregate volumes as much as possible. This would make the packages more attractive to market; facilitate transportation arrangements; aid the marketers in moving volumes to and through market centers; reduce per unit costs; and enhance revenues for both U.S. gas and marketers' own "equity" gas.

All parties would like to see contracts of at least 2 years in length, with a 6-month to 1-year lead time prior to implementation. The lessees would like the MMS RIK program to be "non-terminable" during the stated period; that is, neither the lessees nor the government should be able to switch back and forth between in-value and in-kind royalties.

Minimum Bids

Producers expressed concern over MMS establishing minimum bid values. This concern centered on the mistaken belief that MMS would attempt to turn royalty gas back to the lessee if the minimum bid values were not realized on the spot market. MMS explained that in the RIK context the term "minimum bid" refers to a benchmark that would be used to evaluate and potentially reject bids for term RIK sales.

Delivery Points and Transportation

Delivery Point. The participants were unanimous in their desire that MMS take its royalties at the lease (wellhead or royalty determination point) for the following reasons:

- Most independents sell their production at the wellhead, and would be forced to enter into unfamiliar business practices if they had to transport royalty gas downstream;

- The further downstream MMS moves the delivery point, the more complex and burdensome it becomes for all concerned in areas such as balancing and processing;

- Lessee-negotiated transportation rates may be higher than those currently in place due to lack of experience, thus increasing costs and decreasing revenue; and

- Downstream delivery points increase risks for lessees and creates more overhead costs.

If MMS takes its royalty gas in kind, it would have to expect to take all gas daily because the royalty share is mandatory upon severance of product from the reservoir.

Transportation. Producers stated that there are many complexities to consider in transporting gas and that these have revenue implications as critical as product pricing.

- MMS or its agent(s) could successfully negotiate rates on non-jurisdictional lines as well as on common carriers;

- There are interruptions in transportation at times, but not often because interruptible transportation often is backed up by firm transportation downstream;

- Even under worst case scenarios of not being able to move gas, there are always shippers with transportation capacity locked up that are willing to take gas (however, value is lost in these situations); and

- If MMS sells at the lease, the purchaser risks the potential for discounted prices occasioned by downstream transportation interruption.

Marketers stated that MMS or its agent(s) could theoretically negotiate better transportation rates than currently in place because MMS could direct all its royalty share through one line (rather than over multiple lines as currently is the case for many leases), thus increasing throughput on the selected line and potentially decreasing rates.

Marketable Condition and Commingling

On the OCS, producers stated that MMS should not have any problems in encountering gas that is not in marketable condition.

Reporting and Balancing

Producers stated that it may be difficult to reconcile volumes because MMS does not have a verification system for gas, as it does for oil. However, the lessees stated that such problems will be lessened if gas is taken at the facility/measurement point.

IPAA recommended reporting and payment be simplified and accomplished through a system other than MMS' major accounting system.

All parties agreed that any new reporting requirements result in a net decrease in overall reporting to MMS. That is, attendees cautioned that MMS should not replace its current reporting requirements with more burdensome requirements to support its RIK program. Attendees seem to agree that producers should report volumes, and either the marketer or MMS could report the value component.

The lease and sub-lease level of reporting detail that MMS currently requires would be problematic for marketers, if they were required to report. Marketers generally do not have the need to allocate proceeds to specific leases. A requirement for marketers to allocate to leases would be a disincentive for their participation in RIK programs.

Producers stated that the balancing of production, nominations, and delivered volumes becomes more difficult as you go from Option 1 to Option 4: the farther downstream you go, the more difficult balancing becomes.

Miscellaneous

Participants would like to see MMS simplify the royalty valuation process, whether by RIK or new valuation regulations. However, during the oil workshops, IPAA questioned what direction MMS was trying to go, since we are looking into simplifying things on the one hand with RIK, while we also have proposed "complex" new oil valuation rules.

IPAA urged MMS to give serious consideration to taking onshore gas royalties in kind (specifically, from the San Juan Basin because it has an active spot market), and not disregard the idea because of the "complexities" involved. MMS stated that it will hold a workshop in Farmington, New Mexico to address the special issues associated with onshore gas.

II. CRUDE OIL WORKSHOPS - OUTER CONTINENTAL SHELF

Three options - ranging from conservative to aggressive in approach - were developed to reflect a spectrum of possible RIK programs for crude oil on the Outer Continental Shelf (OCS):

- o Option 1: Enhancement of 1995 Pilot. MMS takes its crude oil at the lease and competitively sells it to the highest bidder, reserving the right to reject all bids.

- Option 2: MMS Crude Oil Marketing. MMS takes title to its crude oil at the platform from various locations across the Gulf, and aggregates, markets, and sells by competitive bid, with assistance of a marketing consultant.

- Option 3: Private Sector Marketing of U.S. Oil. MMS takes royalty crude from many pipelines, and retains one or several marketers to arrange for transportation, aggregation, marketing, and sales on a service basis.

The MMS study team held public meetings/workshops on March 18, 1997, in Houston, Texas, and April 1, 1997 in New Orleans, Louisiana, to discuss and obtain input on the RIK options and associated issues involved in Federal RIK programs for crude oil on the OCS. The meetings were announced in the Federal Register (FR 97-4350) on February 21, 1997. The following summarizes comments on MMS OCS crude oil RIK options made during the public workshops.

General Comments

The consensus of participants - both major and independent producers and marketers - was that they were in favor of MMS taking its crude oil royalties in kind under either Option 1 or 3, subject to the comments below. The primary caveat associated with this consensus was that the "facility measurement point" at or near the lease be the delivery point for the government taking its production in kind. The producers were not in favor of MMS marketing its own crude oil, a possibility developed in Option 2.

The producers also stated that any RIK program implemented by MMS be a "live". operational program as opposed to a more limited "test" program so that MMS could obtain real data on RIK results and producers could enjoy substantial benefits.

Proposed Regulations

The producing side of the industry would like to be involved in any rulemaking that may precede implementation of an RIK program. Specifically, the Independent Petroleum Association of America (IPAA) offered to assist with regulations if MMS commits to pursuing RIK. Also, IPAA would like to work with MMS to pursue a legislative change to the Outer Continental Shelf Lands Act (OCSLA) changing the fair market value definition (similar to a proposed change that was in the original draft of the *Federal Oil and Gas Royalty Simplification and Fairness Act of 1996).*

The producers would like any new regulations to be simple and flexible. They also do not want additional burdens placed on them by the regulations, such as requirements for arranging transportation for U.S. gas or for reporting additional data. Lastly, producers cautioned against the government creating a "non-level playing field" through promulgating self-serving regulations for the transportation of RIK oil.

MMS Marketing of Crude Oil

Attendees did not express any concerns about MMS competing in the marketplace if MMS takes royalty oil at the lease and either sells to a marketer or retains an agent to market for the government. However, there were some concerns expressed over intrusive government if <u>MMS</u> were to get involved in downstream marketing. Additional concerns surfaced about MMS imposing artificial and impractical requirements on pipelines and gathering systems and about MMS not having the expertise to successfully market public resources.

All parties agreed that MMS should seriously consider utilizing private sector marketing expertise to potentially enhance revenues. The attendees further stated that this approach would actually reflect a less intrusive government due to letting the marketplace work rather than having the government second-guessing industry's marketing and sales decisions.

Mandatory Participation, Lease Selection, Aggregation, Contract Terms

Attendees were not opposed to MMS taking its production in kind on a mandatory basis, recognizing MMS' authority under lease terms to take royalties in kind. However, lessees stated their opposition to any attempt by MMS to select only those leases where it appears that the government would realize revenue enhancement. Rather, they would prefer that MMS take production from all leases in a given system or area, and take 100 percent of production from these leases. Independents encouraged MMS to take de minimis volumes in kind to relieve smaller producers from administrative burdens associated with paying royalties. All parties agreed that an RIK program should involve all working interests on a lease and all leases in pooling agreements.

The marketers in attendance stated that aggregation is not as important in oil as it is in gas, because: 1) refiners like to remain flexible, so they tend to stay away from term contracts; 2) anyone can buy anywhere based on NYMEX; and 3) you can sell in bulk at any onshore terminus.

All parties would like to see contracts of at least 2 years in length, with a 6-month to 1-year lead time prior to implementation. Producers stated that the lead time would be necessary for terminating existing contractual commitments for transporting, processing, and selling the royalty share of lease production. MMS was also encouraged to allow at least a 60-day lead time before reverting to in-value royalties, if the RIK program is subsequently phased out. The lessees would like the MMS RIK program to be "non-terminable" during the stated period; that is, neither the lessees nor the government should be able to switch back and forth between in-value and in-kind royalties.

Refiners participating in the current oil RIK program expressed concerns that they would be in competition for the best leases if MMS begins a new RIK program. They feel that the current program should take precedence, and that financial requirements (sureties, etc.) for a new program should be similar to those required in the current program.

Minimum Bids

Producers expressed concern over MMS establishing minimum bid values. This concern centered on the mistaken belief that MMS would attempt to turn royalty oil back to the lessee, if the minimum bid values were not realized on the spot market. MMS explained that in the RIK context the term "minimum bid" refers to a benchmark that would be used to evaluate and potentially reject bids for term RIK sales.

Some representatives expressed concern that MMS would use the value received in the competitive bidding process as a benchmark for in-value payments.

Participants had mixed comments concerning the role the proposed oil valuation regulations might play. Some stated that they could be used to establish minimum bid criteria, while others were concerned that their use as a basis for bids would not be representative of the marketplace.

Delivery Points and Transportation

The participants were unanimous in their desire that MMS take its royalties at the lease (wellhead or facility measurement point) for the following reasons:

- Most independents sell their production at the wellhead, and would be forced to enter into unfamiliar business practices if they had to transport royalty gas downstream;
- The further downstream MMS moves the delivery point, the more complex and burdensome it becomes for all concerned in areas such as balancing and processing;
- Lessee-negotiated transportation rates may be higher than those currently in place due to lack of

experience, thus increasing costs and decreasing revenue;

- Downstream delivery points increase risks for lessees and creates more overhead costs; and
- Producers object to being required to "market" government oil free of charge so that MMS can enhance the value of its royalties.

If MMS takes its royalty oil in kind, it would have to expect to take all oil daily because the royalty share is mandatory upon severance of product from the reservoir.

Marketable Condition and Commingling

On the OCS, producers stated that MMS should not have any problems in encountering oil that is not in marketable condition. There was general agreement that it is the lessee's responsibility to get the production to conform to pipeline specifications, but opposition to "marketing" it downstream.

MMS would not have to worry about commingling issues if it sold its share of production at the wellhead.

Reporting and Balancing

Participants would like to see MMS reduce and simplify reporting requirements, and they expressed opposition to any increases in reporting burden as the result of RIK. From an accounting perspective, producers would need 90 days to convert their systems.

All parties agreed that any new reporting requirements result in a net decrease in overall reporting to MMS. That is, attendees cautioned that MMS should not replace its current reporting requirements with more burdensome requirements to support its RIK program. Attendees seem to agree that producers should report volumes, and either the marketer or MMS could report the value component.

Regarding balancing, producers stated that there are more balancing problems with distance from the lease. Under Option 3 with MMS taking oil at the lease, the marketer would likely be required to address balancing issues

Quality Banks

MMS was reminded that on the OCS pipelines and producers have developed "quality banks" in which shippers are either rewarded or penalized based on the quality of oil blended together into the pipelines. In this way, the pricing effects of oil quality are equitably allocated to those using the pipeline. MMS would need to participate in quality bank agreements if it took its oil in kind.

Miscellaneous

Independents questioned what direction MMS was trying to go, since we are looking into simplifying things on the one hand with RIK, while we also have proposed "complex" new oil valuation rules.

Producers stated that MMS has a chance to make the royalty system more productive and cost effective, reduce government and industry burdens, and provide substantial benefits through RIK. It provides a chance for government and industry to "escape the endless morass of disputers and litigation, lessen audits, and reduce valuation disputes."

As an aside, independents also urged MMS to give serious consideration to taking onshore gas royalties in kind (specifically, from the San Juan Basin because it has an active spot market), and not disregard the idea because of the "complexities" involved. MMS stated that it will hold a workshop in Farmington, New Mexico to address the special issues associated with onshore gas.

III. CRUDE OIL WORKSHOP - ONSHORE

Three options - ranging from conservative to aggressive in approach - were developed to reflect a spectrum of possible RIK programs for onshore crude oil (these options were similar to those presented above for offshore crude oil):

- o Option 1: Enhancement of 1995 Pilot. MMS takes its crude oil at the lease and competitively sells it to the highest bidder, reserving the right to reject all bids.

- o Option 2: MMS Crude Oil Marketing. MMS takes title to its crude oil at the lease, and aggregates, markets, and sells by competitive bid, with assistance of a marketing consultant.

- Option 3: Private Sector Marketing of U.S. Oil. MMS takes royalty crude at the lease, and retains one or several marketers to arrange for transportation, aggregation, marketing, and sales on a service basis.

The MMS study team held a public meeting/workshop on March 25, 1997, in Casper, Wyoming, to discuss and obtain input on the RIK options and associated issues involved in RIK programs for onshore crude oil. The meetings were announced in the Federal Register (FR 97-4350) on February 21, 1997. The following summarizes comments on MMS onshore crude oil RIK options made during the public workshop.

General Comments

The consensus of participants - producers and marketers - was that they were in favor of MMS taking its crude oil royalties in kind under either Option 1 or 3, subject to the comments below. The producers were not in favor of MMS marketing its own crude oil, a possibility developed in Option 2.

An IPAA representative made comments in support of RIK in general and stated that IPAA supports either Option 1 or 3, with the following suggestions:

- Lessees need 6 months to 1 year lead time before project begins;
- The MMS should take product at the lease;
- The term of the project should be at least 2 years;
- The MMS should take all production from an area;
- There should be less frequent payment terms for de minimis volumes; and
- Producers should not be forced to change business practices.

Proposed Regulations

Participants expressed concern about apparent MMS uncertainty and conflicting polices as reflected by the fact that RIK would simplify and streamline royalty payments, while the proposed oil valuation regulations attempt to measure value away from the lease and would be burdensome. They would welcome an RIK pilot, if it was:

- o Strictly adhered to stated objectives of reducing costs for both industry and government and reducing valuation disputes,
- o Designed to be as simple as possible,
- o Adaptable and accommodated operational and market dynamics
- o Easy to phase out if it did not accomplish the stated objectives.

Mandatory Participation

Participants recognized that MMS has a right to take its production in kind. However, producers reserve the right to object to any additional requirements that may be imposed. They felt that they should not be subject to an RIK program that results in increased operational costs, added administrative burden, or reduced product values.

Producers also stated that they would need anywhere from 90 days to 1 year to terminate or amend contracts, because they enter into term contracts for certainty and increased value. They stated that this would not be a good year to start, because the market is volatile and there is uncertainty about what effects the "Alberta Express" will have on the Wyoming crude oil market.

Other recommendations included taking all working interest owner percentages from the lease to avoid value discrepancies and simplify operations and taking marginal producing properties in kind (but not trucked production).

Minimum Bids

There was considerable concern expressed about the concept of minimum bids, much of it because of the fear that MMS would require lessees to meet the minimum bid value in their gross proceeds royalty reporting if MMS decided to leave the lease in value. Also, the IPAA representative stated that IPAA would not support any RIK program whereby MMS rebills in-value paying lessees based on computed "minimum bid values." They strongly object to MMS using NYMEX as a comparison basis for "look back" price adjustments.

Participants felt that minimum bids wouldn't be necessary if MMS received several bids for a package, because the high bid would constitute market value. Also, if MMS didn't receive the minimum bid amount, it has the option of selling the crude oil on the spot market. There was support for using a consultant to sell the oil and building in a performance/incentive clause to help ensure that market value is received. If that were done, minimum bid amounts would not be necessary because the consultant would ensure that MMS was getting fair market value. Also, including a bonus for performance in the consultant's contract may help increase revenues.

Delivery Point and Transportation

The producers support keeping the delivery point at the lease. If the producer or MMS had to transport oil away from the lease, it would increase administrative costs (gravity and sulphur banks, line fill, line loss/gain, etc.).

Participants felt that onshore transportation rates could be negotiated easily. Almost all pipelines are common carrier from the custody transfer points downstream, and everyone is charged basically the same rate.

Marketable Condition

This is a very minor problem because crude is separated and the resulting oil is in marketable condition before measurement and title transfer. Also, Wyoming has very tight specifications, especially on water, that ensure marketable condition. Slop oil or oil skimmed from pits and tank bottoms could be a minor problem, but these grades also usually are put in marketable condition. There could be viscosity problems because some crude oils need blending to meet pipeline specifications, but that is a shipper's problem.

Contract Balancing

Balancing problems will be minimal if the oil is taken at the wellhead or first transfer point, except that trucked leases will have balancing problems if the same transporter is not used. Also, sliding/step-scale leases may pose a problem because royalty shares are not known until end of month. Balancing should be a matter between MMS and its marketer

IV. NATURAL GAS WORKSHOP - ONSHORE

The same options as described above for natural gas were presented at the onshore natural gas RIK workshop, held in Farmington, New Mexico on May 14, 1997. The workshop focused on RIK potential for gas in the San Juan Basin. The following summarizes comments made during the public workshop.

General Comments

The consensus of participants - producers and marketers - was that they were in favor of MMS taking its gas royalties in kind, subject to the comments below. However, several attendees stated that the value of RIK programs in the San Juan would be much greater if Indian production could also be taken in kind.

Producers wanted to know if an RIK program would be a pilot or a "permanent, live program". Some small producers wanted to know if they could also use the government's marketer(s) if a program occurred so that revenues could potentially be enhanced.

Balancing

Some producers were concerned about adding another player to the agreements for balancing lease production volumes. Some said that having a split stream for two marketers where there is now one stream would be a complication. However, other producers and the gas marketers stated that split streams are already common.

The question of how to balance volumes with the government at the end of the RIK term and at the end of lease life came up, with no single solution offered. Generally, producers stated that MMS would simply be another working interest owner, or, alternatively, MMS could stipulate by regulation that it would simply be entitled to its royalty share entitlement with true-up every year.

Capacity Constraints

MMS was informed that there are now frequent capacity constraints on San Juan Basin pipeline systems, especially the gathering systems, and that these can be severe enough to curtail production. Some producers did not see this as a problem for MMS RIK, because there would not be any more production leaving the Basin. However, others thought that MMS in-kind production could be curtailed if producers decide to more fully utilize their own gathering contracts for expanded production.

Marketable Condition

This is a potentially major problem for RIK in the San Juan Basin due to the transportation and treatment costs associated with CO_2 in coalbed methane production. Currently, lessees incur costs to transport the coalbed methane with its CO_2 component to treatment plants where the CO_2 is removed at further cost. As a policy matter, MMS considers most of the cost to transport the CO_2 and treat the coalbed methane for CO_2 removal to be costs to place production in marketable condition, a cost non-deductible from royalties. At the meeting, producers informed MMS that the non-deductible costs for CO_2 transportation and treatment average from 7 to 15 cents per MMBtu.

At the workshop, MMS representatives explored with the attendees whether there was a "win-win" solution under an RIK program in which: 1) lessees could be relieved of their duty to place product in marketable condition and 2) the United States could realize at least as much royalty revenue through RIK sales as currently received in value. Producers and marketers unanimously stated that there is no such win-win solution because the margins for re-sale of natural gas are only in the 1 to 2 cent range. MMS representatives stated that, without compensation for currently non-deductible costs, RIK for San Juan Basin gas would likely be revenue negative, and thus is not a good candidate for an RIK initiative.

Producers stated many leases have both conventional and coalbed methane production but that there is very little mixing before treatment plants. Producers also stated that they would object to the idea of the government only taking conventional gas in kind because of potentially increased costs to maintain two types of systems on the same properties and areas.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON RESOURCES

STATEMENT SUBMITTED BY STATE OF LOUISIANA TO SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

The Department of Natural Resources of the State of Louisiana, as oversight agency for the development of mineral resources from state owned lands and waterbottoms, has a vested interest in the issue of federal take-in-kind royalty from offshore production due to the fact that Louisiana receives a monetary share of royalty paid to the federal government on 8(g) production. The position of the State of Louisiana can be concisely summed up as follows:

The State of Louisiana does not at this time have the personnel, agency expertise or budget nécessary for it to properly market oil and gas produced from State owned lands and waterbottoms. Such a function would require hiring, either under private contract or as part of the civil service system, marketing experts, economic forecasters, economists, minerals futures analysts, etc. at a prohibitively large increase in the budget. Accordingly, if the State of Louisiana received its share from royalty on 8(g) production in-kind, the same prohibitive budget increase for additional personnel would be necessary or the State would have to hire a private marketing agency to market its in-kind product. In either case, the State would not likely benefit from any potential increase in its royalty share in that the cost of marketing would more than offset any increase in value received for the sale of in-kind product.

The State of Louisiana is presently restricted by statutory law, namely: La. R.S. 30:142-144, as to how it may dispose of any in-kind royalty product. With regards to in-kind royalty gas, La. R.S. 30:142 states that sale must be by public bid unless the gas is being used to satisfy human needs. That statute goes on to define human needs as:

1.) Maintenance of gas and electrical services for residences, correctional facilities or publicly owned water, sewerage and drainage facilities.
2.) Maintenance of agricultural operations.
3.) Maintenance of commercial and industrial business activities utilizing less than three thousand Mcf on a peek day.
4.) Maintenance of public services provided by municipal, cooperative or investor owned utilities who come under numbers 2.) And 3.) herein above.
5.) Maintenance of depressed energy-intensive industry which meets certain specified requirements.

Then, even if the use to which the gas is put meets one of the above requirements, the Public Service Commission sets the minimum sales price. In-kind royalty oil, under La. R.S. 30:144, is limited to sales to small refineries.

The limitations imposed on the sale of in-kind royalty product by statutory provision negate any marketing strategy thus depriving the State of the possibility of increased revenue derived from the sale thereof. The present statutory scheme for handling in-kind royalty would have to be changed by the Legislature of the State of Louisiana for the State to be able to take advantage of marketing its own in-kind royalty product.

The possibility of regulations, presently the subject of speculation, and proposed Louisiana mineral lease changes which would set the market value of royalty oil at the spot price of oil at an aggregating facility such as Empire or St. James would dictate that the State of Louisiana, without sufficient marketing expertise to "trade" oil at different locations around the country, would be forced to sell at the best price it could get in the area. Accordingly, the State would not be interested in receiving in-kind royalty oil unless the State could guarantee a sale at a price equal to the spot price at the aggregating facility, which the State, under the royalty value clause of State mineral leases compels its Lessee to obtain and pay the proportionate royalty value to the State, and its purchaser could receive a sales price greater than the spot price at the aggregating facility.

The State of Louisiana, in performing audits for the Minerals Management Service on production in the 8(g), is well aware that the federal government may not be getting its proper royalty value from production in the 8(g) and may benefit from taking in-kind royalty and marketing its product. Because the federal government may have the requisite personnel, expertise and budget to adequately perform the marketing function, the value received for sale of in-kind royalty product would possibly exceed the royalty value received when the lessee sells the royalty portion of production. However, at this time, the State, for the reasons set forth herein above, does not feel that it would benefit by taking in-kind its share of royalty from production in the 8(g). Nevertheless, conditions could change and circumstances could arise that would make it desirable for the State to take its share of 8(g) production in-kind. Therefore, the State of Louisiana would support legislation that gives the State such an option.

Jim Magagna

Director of the Office of State Lands and Investments

Director of Federal Land Policy

Madam Chairman, Members of the Subcommittee, I am Jim Magagna, Director of the Office of State Lands and Investments and Director of Federal Land Policy for the State of Wyoming. I applaud your initiative in providing this important forum for a dialogue on the issue of royalty in-kind. The State of Wyoming, under Governor Jim Geringer, has assumed a leadership role in seeking development and implementation of a cost efficient, effective federal royalty in-kind program providing an opportunity for full participation by affected states. We are appreciative of this opportunity to share our efforts and expectations with members of the Subcommittee.

Wyoming's intense interest in a royalty in-kind program for federal oil and gas royalties is based, in part, on experiences and frustrations with the current federal royalty program. The affected states are recipients of fifty percent of federal mineral royalties on a "net receipts sharing" basis. Better explained, the states receive fifty percent of the net royalties after a deduction of up to 25% percent of the costs of administration of the minerals program. Wyoming has long been frustrated in its efforts to obtain a full accounting for these deductions. In 1993 the State completed a study of the projected cost of administration of a state operated royalty administration program. We remain confident that this study has demonstrated that a state designed program meeting all basic federal requirements could be operated at a significant cost savings to both state and federal royalty recipients. However, lack of full disclosure of cost breakdowns for the federal program has precluded direct comparison.

When, in 1995, the Department of Interior announced its proposed devolution of the Minerals Management Service (MMS) functions to the states, Wyoming was quick to come to the table. However, devolution proved to be the elusive greased pig--always just beyond reach. The proposal was withdrawn without opportunity for meaningful dialogue on acceptable terms for implementation.

Wyoming worked closely with members of Congress, in particular our own delegation, to assure that delegation of royalty functions to the states was contained in the Federal Oil and Gas Royalty Simplification Act (FOGRSFA). Although we were successful in this effort, the final language was more limiting in delegable functions and provided for greater Secretarial discretion than we had sought.

Since passage of FOGRSFA we have worked diligently with MMS in development of Standards and Guidelines for implementation of the Section 205 delegation provisions. Wyoming has represented the Western Governors Association in this process. Consistently, MMS has given a very narrow interpretation to functions that are delegable to the states. Similarly, MMS has generally maintained that, in assuming delegable functions, the states would be required to use the same processes and forms that are currently used by MMS. These constraints leave no opportunity for state inventiveness and operate counter to the express purpose of delegation--reduced administrative costs.

Members of the Subcommittee are familiar with the current effort by MMS to develop new methodologies for valuation of royalty oil. Wyoming supports this effort insofar as it is a recognition of the difficulties in valuation caused by nonarms-length transactions between affiliates. However, we remain concerned that the proposed valuation based on NYMEX pricing does not sufficiently relate to the realities of the regionalized Wyoming marketplace. We are not confident that a valuation approach can be devised which will have common geographic applicability. While Wyoming's interest in a royalty in-kind approach precedes this MMS valuation initiative, we believe that the difficulties with oil valuation demonstrated by many of the comments on the proposed rulemaking provide added incentive to all interests to seriously consider royalty in-kind.

While each of these experiences has provided a powerful incentive for Wyoming to call for a re-engineering of the federal royalty program, we are equally motivated by the opportunities for revenue enhancement provided by a carefully designed royalty in-kind program. Significant ongoing enhancement will result from major cost reductions associated with a program that no longer relies on collection, analysis and auditing of pricing data. More importantly, we believe that the marketplace holds rewards for those who are willing to bear the risks normally associated with participation in the private sector. The State of Wyoming is prepared to assume these risks as to its share of federal royalty oil.

The 1997 Wyoming Legislature took the first significant step toward positioning the state to take its share of federal mineral royalties in-kind. The Legislature passed and the Governor signed into law Senate File 148, now Wyoming Statutes 9-4-601(g). This subsection provides:

> The state, should federal law not proscribe such action, is authorized and empowered to receive its gross percentage share of federal mineral royalties from the production of oil and gas which is due under the provisions of the act of congress of February 25, 1920 (41 Stat. 437, 450; 30 U.S.C. §§ 181, 191) as amended, in the form of the actual production from federal mineral leases covered under that act of congress. If directed by the governor, the production shall be taken by the state in lieu of royalty receipts. The production shall be taken in the same percentage of volume as the gross percentage of royalty proceeds allowed by the act of congress. Any sale or disposal of the production shall be administered by the director of the office of state lands and investments or his designee. The director, subject to criteria established by the governor, shall sell or dispose of any production taken by the state from federal mineral leases. Prior to receipt of any royalties, the director shall promulgate necessary rules and regulations to carry out this subsection.

MMS, in February, issued draft options for a federal royalty in-kind feasibility study for on-shore oil to be conducted in Wyoming. In response to this proposal, Wyoming presented to MMS a proposal to allow the State of Wyoming to take its share of federal royalty in-kind and market same during the term of the proposed federal pilot project. The Wyoming proposal including an example of how it might operate in one Wyoming county, Campbell, is provided as Attachment A to my testimony. While this pilot proposal has received favorable response from MMS staff, it is our understanding that MMS believes it is currently lacking statutory authority to effect a direct transfer of royalty oil to a state. A pilot project could be a useful tool in testing the design of a royalty in-kind program. However, due to the limited volumes involved in a pilot resulting in negative economies of scale for both market power and administrative costs, it should not be viewed as a comparative test of net returns.

In April of this year I had the opportunity to travel to the Province of Alberta to visit with industry and provincial officials regarding the successful royalty in-kind program operated by the Ministry of Energy. I was accompanied by two legislative leaders and a member of my staff. There are important differences in the Canadian situation. Significant among these is that ownership of government minerals rests not at the federal level, but in the provinces. The evolution of the current Alberta program has little opportunity for parallel in the U.S. As I understand this program, prior to 1985 the province took possession of 100% of production through the gathering process, then transferred to producers their share. Following deregulation in 1985, the provincial royalty share was marketed by the Alberta Petroleum Marketing Council who would also market for independent producers for a per barrel flat fee. Beginning in 1995, apparently due to pressure against government competition and program costs, the province contracted for private sector marketing. Many of the fundamental components of the current Alberta approach represent a useful starting point for development of a federal royalty program.

There are several key elements to making a royalty in-kind program successful and acceptable to Wyoming:

1. The states must have the right to receive at or near the lease its 50% gross share of federal royalty oil and gas.

2. The states should have the opportunity to receive and market the federal share of federal royalty oil and gas provided the state offers a price no less than that otherwise available to the federal government.

3. The state and federal royalty interests must maintain the right to receive a cash royalty payment for de minimus production.

4. The states' share of federal royalty oil equals fifty percent. Participating states retain the full net proceeds from sale. States opting to receive a cash payment from federal in-kind royalties receive a payment of fifty percent of net federal proceeds less a deduction of no more than the actual administrative costs of the federal in-kind program.

5. Reporting and auditing requirements for participating states are limited to those necessary to collect and verify lessee production and delivery volumes.

I am aware of several principles which have been developed by industry organizations which I believe will be presented in later testimony. Wyoming generally supports these principles.

Proper design and implementation is critical to the success of a royalty in-kind program. The program must reflect the concerns and the input of the states, producers, marketers and the MMS. Program design should not be confined by the constraints of current legislative authority. Rather, Congress must be prepared to give clear legislative authorization and direction to a program with the potential to maximize net returns to the state and federal royalty interests while minimizing burdens on oil and gas production.

While adequate time must be devoted to program design and implementation, there are two key market factors affecting Wyoming which cause us to urge you to move expeditiously. On the oil side, Wyoming producers are beginning to see significant market impacts from the flow of Canadian oil into Padd IV markets as a result of the Express Pipeline. Negative price, and therefore royalty and tax, impacts can perhaps be countered by more aggressive marketing of Wyoming production. This effort could be substantially enhanced by the State's ability to aggregate and offer a significant volume of royalty oil.

Wyoming contains one of the most significant remaining reserves of natural gas in the United States. The primary current opportunity for market growth exists in the midwestern and eastern states. This opportunity too has caught the attention of Canadian producers. There are currently up to seven proposed pipelines and pipeline expansions to move Canadian gas into these markets. The state has undertaken several initiatives including a gas marketing project and a Gas Fair to seek new market opportunities. Our ability to offer assured long term gas supplies could likewise be enhanced by a royalty in-kind program.

The State of Wyoming is committed to being a leader in a partnership to develop a federal royalty in-kind program containing the elements which I have outlined. The states, MMS and industry can benefit from a properly designed program. Our experience with development of the Section 205 Standards and Guidelines, which I earlier addressed, provides a clear lesion on the need to have all interests simultaneously involved in the design process as full players. I urge Congress to provide a clear expression of its support for the royalty in-kind concept and a truly collaborative process for its development and implementation.

I thank you for your careful consideration of my comments. Wyoming stands ready to assist you in moving forward with this initiative.

ATTACHMENT
A

MARCH 25, 1997

WYOMING PROPOSAL TO TAKE STATE SHARE OF FEDERAL ROYALTY IN-KIND OIL

The State of Wyoming hereby offers an additional option to the Minerals Management Service' February 21, 1997 draft options for a federal royalty in-kind feasibility study onshore (Wyoming). That is: <u>The State of Wyoming be allowed to take its share of federal royalty in-kind and market samė during the term of the proposed federal pilot program.</u>

<u>ASSUMPTIONS</u>

This State option proposal is proffered under the assumptions that:

*Federal lessees/operators will be under a mandate from MMS to participate in a royalty in-kind pilot, delivering State share royalty production as directed by the State.

*The primary goal of the pilot project is revenue enhancement for the in-kind royalty share volumes taken, if and when taken, during the term of the pilot.

*Consideration will be given to the State's sharing in federal pilot program funding for the administrative costs related to in-kind royalty volumes taken.

<u>PILOT FOCUS</u>

The State proposes a pilot in-kind royalty oil program focusing on:

*Federal unitized production from high-volume units from which the State also currently receives a production allocation, and federal unitized presence is a significant percentage of total unit production.

*Taking initially from an area with sufficient transportation capacity and proximity to the Rocky Mountain market center within Wyoming.

*Taking initially from an area with significant proximate production concentrations - Example: a by-county or township concentration.

March 25, 1997
State Royalty In-Kind Proposal - Federal Production Share
Page 2

PROGRAM BASICS

Proposed program basics for State R-I-K pilot:

*State share of federal in-kind royalty oil production available on a competitive bid basis only, on a total available unit or field basis, inclusive of State in-kind royalty oil volumes, as a minimum. Total royalty in-kind volume shares (federal/State) from all units in the aggregate may be bid.

*Bid package to include call for bids detailing bidder requirements, sample contract and property schedule.

*Bids received to be compared to current market and current net royalty value as a basis for acceptance or rejection of high bid(s).

*Reservation of right to reject any and all bids and receive direct cash royalty payment for State share marketed by federal lessees/operators.

*Purchaser(s) assume(s) all responsibility for taking delivery, transporting and marketing crude beyond custody transfer tankage.

*Requirement for purchaser(s) to take or pay for all State share in-kind royalty produced volumes on a monthly basis.

*In-Kind purchaser to retain all revenue from downstream sale and provide payment monthly on all volumes at contract price.

ACCOUNTING CONSIDERATIONS

*Use existing State bid package and contract documents, modified as necessary to accommodate federal production issues.

*Federal and State lessees/operators to continue reporting to respective agencies as applicable.

*State receives monthly a report of unit sales volumes supported by crude run statements/purchasers statements as verification base documentation.

*Production verification accessible electronically from Wyoming Oil and Gas Conservation Commission and Department of Audit computerized access to federal forms 3160 and 2014.

*State costs should not increase dramatically assuming cooperation from State and federal agencies and lessees/operators, and given existing direct relationships with producers/operators and proximity to the area.

*Purchaser of in-kind royalty provide electronic funds transfer to State Treasurer, acknowledgement documentation to Office of State Lands and Investments along, with custody transfer pipeline and truck run tickets to support volumes purchased.

Example County: Campbell, Wyoming

*Federal production approximately 52% of total county crude production.

*State in-county production approximately 6%.

*The first ten units (arrayed in order of descending volume) within county in which State/federal production exists, would yield greater than one-thousand barrels per day as State's share of in-kind royalty available for sale.

Target County: **Campbell County, Wyoming**

1996 Monthly Volume:
Federal - 715,673 bbls (52.03% of County Production)
State - 85,545 bbls (6.22% of County Production)

Federal Units:

	Volume	Federal Interest	State Interest
Hartzog Draw (Johnson County also)	430,512 bbls	70%	2.5%
North Buck Draw (Converse County also)	331,637 bbls	55%	07%.
Sandbar East	51,913 bbls	90% Muddy "A" 40% Muddy "C"	05%
Alpha	41,009 bbls	72%	04%
Highlight	40,942 bbls	28%	04.9055%
Raven Creek	36,631 bbls	24%	11.8111%
Rozet	37,161 bbls	96% Minnelusa 32% Muddy	00% 02.9208%
House Creek	34,374 bbls	53%	08.41%
Bone Pile (Converse County also)	30,024 bbls	09%	.000164
Pine Tree	26,351 bbls	100% Shannon "E" 82% Shannone "CE"	00% 00.71808%
Lone Cedar	23,060 bbls	03%	46.195019%

FOLLOW-UP ADDRESS:

Jim Magagna, Director
Office of State Lands and Investments
122 West 25th Street, 3W
Cheyenne, Wyoming 82002

307-777-6629
307-777-5400 Fax
jmagag@missc.state.wy.us

Written Statement by
Larry Nichols
President and Chief Executive Officer
Devon Energy Corporation
representing
Independent Petroleum Association of America (IPAA)
Domestic Petroleum Council (DPC)
California Independent Petroleum Association (CIPA)
Colorado Oil and Gas Association (COGA)
Independent Petroleum Association of Mountain States (IPAMS)
Independent Petroleum Association of New Mexico (IPANM)
Louisiana Independent Oil and Gas Association (LIOGA)
National Ocean Industries Association (NOIA)
New Mexico Oil and Gas Association (NMOGA)
Oklahoma Independent Petroleum Association (OIPA)
Petroleum Association of Wyoming (PAW)
Rocky Mountain Oil and Gas Association (RMOGA)
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
July 31, 1997

Dear Madam Chairwoman and Members of the Committee:

I am Larry Nichols, president and CEO of Devon Energy Corporation ("Devon"), an independent producer who has federal onshore production. I am here today on behalf of Devon and CIPA, COGA, DPC, IPAA, IPAMS, IPANM, LIOGA, NOIA, NMOGA, OIPA, PAW and RMOGA.

Madam Chairwoman, members of the Committee, we always appreciate the opportunity to work with you in the pursuit of a more simple, certain and efficient program for collecting revenues due the Treasury and states from federal oil and gas production. During the 104th Congress, I testified before this Committee to encourage the Minerals Management Service (MMS), states and industry to seriously examine royalty in-kind as a possible alternative to the increasingly complex and contentious requirements for paying royalties on gas production. At the close of the 104th Congress, much progress was made in advancing royalty in-kind. We were encouraged by the report language contained in MMS' 1997 appropriation requiring them to pursue additional oil and gas pilots for royalty in-kind.

During the past year, the need to explore for alternatives to re-engineer the royalty collection system has dramatically increased. Through proposed rulemakings for both oil and gas, the MMS plans to add more and more complexity and uncertainty to the royalty collection system. Quite frankly, we are headed the wrong direction. These rulemakings would have the federal government chase its molecules to remote markets far removed from the lease and "net back" using complex and other undefined and arbitrary formulas to the wellhead in an attempt to estimate value at the lease.

Such a system will be costly for the taxpayers and encourage disputes over what costs can be deducted to estimate a wellhead value. For over 25,000 leases spread throughout the western United States and the Gulf of Mexico, it is not a simple task for the federal government to netback from burner tips and gas pumps to the wellhead, especially during this era of deregulation. This type of net backing scheme will only result in winners and losers at the wellhead, including the federal government.

If a producer decides to sell its production at the wellhead and not participate in the downstream market, then the value received at the wellhead is appropriate for royalty payments, not theoretical netbacks. Deciding to participate in markets beyond the lease presents a new area of risks, costs, and rewards--significantly different from those undertaken to produce the oil. Yet, MMS is proposing rules which expect producers to undertake those risks by entering into a midstream market at no cost or risk to the government. In addition to being intrusive into private business practices, this approach disregards lease terms which require royalties to be paid on the value of production removed or sold from the lease, not on the value of natural gas marketed in New York City or oil marketed in Cushing, Oklahoma, at no cost to the government.

If MMS wants to derive value from downstream markets, they have the means readily at hand -- royalty-in-kind. All of the agency's concerns and perceived problems over how to value royalty could be addressed by a royalty in-kind program. The MMS seems to concur based on the many public statements it has made since 1994. Again and again, MMS has stated that royalty in-kind "will simplify government procedures, streamline reporting practices, eliminate duplication and waste, and provide better services at reduced cost to taxpayers and other customers." Further, the MMS has claimed that royalty in-kind could remove them from "the complex practice of determining the appropriate value of production and eliminate disputes."

We couldn't agree more that an appropriately designed royalty in-kind program may result in these benefits, recognizing that the analysis may be different for oil than for gas. One of MMS' very own consultants for royalty valuation matters has stated, "The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in kind for sale."(See attachment). The consultant could not have said it better. Royalty in-kind accurately measures value by capturing all value resulting from a transaction between a willing buyer and a willing seller at or near the lease. By taking in kind, MMS should gain benefits. It will bring to an end its valuation controversies with lessees. The MMS will have the opportunity to earn higher rewards than the market holds for successful risktaking.

You are probably wondering why even a small independent who always sells at the wellhead and currently is allowed to pay royalties on gross proceeds is in support of a royalty in-kind program. Why would this type of producer be willing to deliver a royalty fraction of its production to the government? With each change to the valuation regulations, the MMS continues to encroach on the principle on which independents conduct their businesses: that production is best valued by sales at the lease, not by downstream transactions. For example, the current proposal for valuing oil royalties emphasizes downstream prices over prices a producer receives at the wellhead. With each rulemaking change, MMS discriminates against companies by desiring all producers to undertake downstream risks, free of cost to the lessor, and in essence punishes independents by regulating an expanded duty to market. The only way a producer can be certain that MMS will never mandate marketing for wellhead producers or require payment of phantom income is to have MMS or the states take the entire federal royalty stream in-kind.

We strongly support MMS' current initiative to study the option of marketing its own royalty oil and/or gas. In response to the FY 1997 appropriations report language, the MMS held a series of workshops across the country to discuss the feasibility of moving ahead with a royalty in-kind re-engineering project. During these workshops, I believe MMS heard a consistent message from the oil and gas industry--yes, we are interested in determining the feasibility of designing a royalty in-kind program which will result in a more a simple and certain royalty collection system.

We acknowledge that there are a number of design issues, depending on whether the royalty stream is oil or gas, that need to be resolved before the government moves forward with a royalty in-kind program. If all parties can agree to the mission and principles of a successful royalty in-kind program, timely resolution of design issues is likely. During MMS' royalty workshops held this spring, we agreed to outline for MMS and states the goals, principles and design elements of a successful royalty in-kind program. To initiate this process, representatives from a number of oil and gas associations from across the country have formed a royalty in-kind workgroup (workgroup). After a number of meetings, I am glad to report to the Committee that the workgroup has developed a mission statement and principles for designing a successful royalty in-kind program:

A Royalty In-kind Mission Statement

To design a federal royalty in-kind program that will eliminate valuation uncertainty and that will be attractive to federal, state, and private sector stakeholders while recognizing the differences between oil and gas production.

Description of Royalty In-Kind Principles

1. Reduce administrative and compliance burdens while providing the opportunity for federal and state governments to maximize their revenues.

The MMS and states. The MMS and states should have the ability to optimize value by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. The potential for increased revenues will require the MMS to manage risks and costs associated with marketing royalty oil and gas.

Producers. Federal lessees should not realize an increase in administrative costs or experience operational burdens, but have certainty through elimination of disputes associated with royalty valuation. Similar benefits will also accrue to the government. An effective royalty in-kind program should not impose upon lessees any costs or obligations beyond the lessee's obligation to deliver at or near the lease. Reporting should be related to volumes produced and delivered, not sales prices or other related valuation information.

Marketers. Marketers should be provided a business opportunity which has an acceptable risk/revenue ratio thereby enticing participation by the most professional and successful marketers in the business.

2. Require transactions at or near the lease that fulfill the lease obligations.

The royalty in-kind production must be delivered at or near the lease. The government must give sufficient notice and take for a certain minimum period of time. Once delivered at a royalty in-kind delivery point at or near the lease, the lessee's royalty obligation must be completely satisfied. A lessee has no duty to market or transport the government's oil or gas past this point. All risks and costs incurred downstream of the royalty in-kind delivery point should be borne by the lessor or its purchaser, in the hope of realizing maximum revenue from reselling the production downstream.

The purchaser who takes delivery at the royalty in-kind delivery point is actually taking from the government and performing under a separate contract. The lessee and the government's purchaser have no contractual relationship with each other. An effective royalty in-kind program should not hold the lessee liable for the purchaser's failure to perform under the royalty in-kind contract, nor should it hold the purchaser liable for the lessee's failure to perform under the lease contract.

3. Provide that when the government takes in-kind it must take all royalty production for a time certain.

If the government takes its royalty in-kind, it must give sufficient notice, and, for a time certain, take the full royalty fraction tendered by the lessee(s) from a given property. The government has no right under the lease to defer its take obligation or leave its production in the ground. The government has no right under the lease to defer any production from either new or existing leases. Otherwise, lessees will be unfairly burdened by having additional marketing and operational problems with which to contend.

4. Require use of private marketing expertise to streamline government operations.

The government's oil or gas should be marketed through a competitive, privatized system in order to maximize benefit and streamline government operations.

5. Provide the states with the opportunity to be involved in designing and implementing the program.

At couple of states - Wyoming and Texas - have been actively promoting royalty in-kind concepts. In addition to being actively involved in the design of a government royalty in-kind program, the states need to be given the opportunity to participate in the marketing of federal royalty stream taken in-kind. While states should be given latitude in marketing federal royalty oil, any program for state marketing should follow these six royalty in-kind principles.

6. Make royalties taken in-kind broadly available for public purchase.

The purchase of hydrocarbons subject to this royalty in-kind program should be made available on an open competition basis to a broad-based public market. This should include providing the opportunity to market to a broad group of interested and qualified marketers.

The workgroup is now compiling a list of design issues. A sampling of design issues include handling new production when it comes on line, transportation arrangements for the government (or its marketers) for privately owned lines, balancing, processing, equity production, producer obligations for transportation, liabilities of the marketer, an open and fair competitive system for in-kind volumes, and notification and other administrative burdens. Design issues should not discourage us from continuing to explore royalty in-kind.

To determine if a successful royalty in-kind program is feasible, the workgroup will attempt to resolve these issues. As conclusions are drawn, we will meet with marketers, states, and MMS to ensure our conclusions accommodate their needs. After attempting to reach agreement with all affected parties, we will provide a full report of this process to the Committee. We hope to be able to submit this report to the Committee within 90 days.

State and foreign governments appear to have successful in-kind program. Their experiences can guide us in designing a successful royalty in-kind program. As compared to these other models, it does appear that MMS could achieve dramatic administrative cost savings over its current system of royalty in value. For example, the Province of Alberta, Canada, currently employees only 33 people to run a royalty in kind program which sells 146,000 barrels of oil per day. The MMS employs hundreds more employees for an equivalent amount of production. In fact, the MMS continues to receive appropriations for more and more auditors year after year. The agency and states could dramatically reduce costs -- if the program is properly designed -- and, by assuming certain costs and risks, potentially increase royalty income.

Again, the MMS consultant agrees: "There would be some overhead costs associated with marketing the oil, however, the cost savings in auditing and compliance, coupled with higher value, could prove to be quite advantageous to a state agency." However, MMS seems hesitant to accept even their own consultant's advise and counsel because they believe their 1996 gas royalty in-kind experiment lost revenue. We believe it is not appropriate for MMS to draw this conclusion because the gas experiment had a number of design flaws which prevented MMS from obtaining additional revenues.

There are a number of ways in which the pilot could have been improved to achieve higher bids. The agency made some mistakes, such as taking gas during mid-winter, not providing sufficient notice and information to bidders, preparing incomplete bid packages (including errant index points, no transportation information, no quality information), not aggregating volumes in a meaningful way (thereby preventing the warranting of minimum volumes), and not examining closer the cost to move through privately owned lines. These mistakes, combined with the fact that MMS chose not to assume any costs or risks associated with the downstream market, produced bids that were lower than might have otherwise been obtained. The truth is that no third party non-producer marketers successfully bid on the gas taken in-kind during the experiment.

The manner in which MMS quantified the alleged "loss" is flawed as well. In simple terms, the MMS believed it was obliged to try and approximate the exact price producers would have been paid for gas the government chose to take in-kind. First of all, there is something inherently wrong with this type of analysis. When it sells royalty in-kind, the prices MMS receives under the given conditions of the sale, such as point of sale, quality of the production, length of the contract's duration, and so forth, are the fair market values for that production . If the government believes it needs to compare expected royalty payments to in-kind proceeds for regulatory scoring purposes, the approach MMS took is suspect. The MMS tried to approximate what royalty payments would have been for in-kind volumes by projecting forward from royalty payments made during the previous year. Market conditions are not static. Market conditions last year or market conditions for production from other leases in the Gulf of Mexico, do not have a direct correlation to market conditions being experienced by MMS for its in-kind volumes, or for other volumes being produced from that same well.

Before "scoring" of the impacts of a royalty in-kind program is pursued, we suggest that economic experts be consulted to reach agreement on the appropriate measures. For more detailed comments regarding revenue neutrality, please refer to the testimony being presented by Mr. Fred Hagemeyer with Marathon Oil Company.

Before MMS moves forward with a royalty in-kind program, we need to build a royalty program that adheres to the six principles discussed above, corrects the flaws of the gas experiment and accommodates all design issues. Furthermore, we need to determine if there are legislative and regulatory barriers which will prohibit successful implementation of a well designed royalty in-kind program. As a starting point for legislative changes, we need to reexamine the legislative language for royalty in-kind that was agreed to during the 104th Congress as part of the Federal Oil and Gas Royalty Fairness and Simplification Act of 1996 (Act). As you will recall, even though this language had the support of MMS and industry, it was eliminated from the Act on the Senate-side due to procedural rules related to budget bills. After a successful royalty in-kind program has been built, we will then be better able to determine if the type of legislative language contained in the Act is appropriate.

In conclusion, I ask for the Committee's support to have states, MMS, and industry to timely complete a comprehensive report of what must occur operationally and legislatively for a royalty program to be successful. A poorly designed in-kind program or test of a program, will result in a royalty in-kind being shelved prematurely.

For all who support reinventing government, there is no better project than in-kind. Together we can determine whether in today's oil and gas environment, we can create a royalty in-kind program that will ensure the government and states are receiving their full value for production from federal lands while at the same time reducing costs for all affected parties.

CRUDE OIL ROYALTY PAYMENT ANALYSIS

Report to the State Lands Offices of Colorado, New Mexico, and Texas

February 21, 1995

Summit Resource Management, Inc.
P. O. Box 797467
Dallas, Texas 75379

Methods for Future Enforcement

Improved Payment Regulations:

The first step in achieving better ongoing payment from the oil companies would be clearly defined regulations which let the oil companies know that royalty and tax payments should be based on the true market value, or the *actual net final* value received. If the oil companies know that the state governments are aware of the true market value and expect payment on such a basis, the likelihood of compliance should increase dramatically. Summit suggests that regulations be written to require that the oil companies pay their royalties and taxes based on "*the actual final net value received for sale of crude oil produced from the lease, including all considerations, trades and exchanges, commodity center sales, transportation, and other deductions where appropriate.*" If this is not possible due to an oil company taking the crude oil to its own refinery, or for any other reason, then the tax and royalty price should be "*the fair market value which could be reasonably expected to be received for final sale of like crude oil at the same lease location by a crude oil marketing organization with a level of sophistication similar to that of the responsible party.*" Once new regulations have been implemented, they would, of course, need to be actively enforced to help the oil companies understand what is expected of them. The state agencies responsible for enforcement would need to be educated in crude oil marketing, and the oil company payment personnel would need to be educated in the new regulations.

Audits:

Detailed audits of previous payments by a qualified auditor, skilled in crude oil marketing, would need to be conducted in order to prove tax or royalty underpayments. It would be necessary for the auditor to trace all crude oil trades, exchanges, and final sales. This would therefore require that the auditor have the necessary experience and knowledge to know where to look for documentation of unwritten or un-linked trades which may have been deliberately put in place to evade audits. It is very possible that at least some of the oil companies would cooperate with the state agencies after learning that the states had the auditing expertise to locate the underpayments.

Take-In-Kind Programs:

The [illegible] way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in-kind for sale by the state agency. This can be very effective in locations where the volume of royalty oil is large, but it may be impractical where the state's royalty oil is small or where additional physical facilities would have to be built to segregate the state's oil. There would be some overhead costs associated with marketing the oil, however, the cost savings in auditing and compliance, coupled with the higher value, could prove quite advantageous to a state agency. For example, in the Yates Field, the State of Texas has recently received an average of approximately $2.00 over posted price and significantly in excess of the other reported prices for the same field. On small leases and in tax compliance, however, an in-kind program would not be practical.

Statement for the Record
Larry Nichols
President and Chief Executive Officer
Devon Energy Corporation
representing
Independent Petroleum Association of America (IPAA)
Domestic Petroleum Council (DPC)
California Independent Petroleum Association (CIPA)
Colorado Oil and Gas Association (COGA)
Independent Petroleum Association of Mountain States (IPAMS)
Independent Petroleum Association of New Mexico (IPANM)
Louisiana Independent Oil and Gas Association (LIOGA)
National Ocean Industries Association (NOIA)
Natural Gas Supply Association (NGSA)
New Mexico Oil and Gas Association (NMOGA)
Oklahoma Independent Petroleum Association (OIPA)
Petroleum Association of Wyoming (PAW)
Rocky Mountain Oil and Gas Association (RMOGA)
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
July 31, 1997

FRED D. HAGEMEYER
COORDINATING MANAGER - ROYALTY AFFAIRS

Madam Chairman and Members of the Committee:

I am Fred Hagemeyer, and I am pleased to be here this afternoon representing Marathon Oil Company, a wholly-owned subsidiary of USX Corporation. Marathon is a fully integrated oil company with 1996 revenues of $16.3 billion. The company is involved in worldwide exploration, production, transportation, and marketing of crude oil and natural gas, and domestic refining, marketing, and transportation of petroleum products. Marathon's 1996 domestic production from 20 states was 122,000 barrels per day of crude oil and natural gas liquids, and 676 million cubic feet per day of natural gas. Marathon has the nation's eighth largest refining capacity with refineries in Garyville, Louisiana; Texas City, Texas; Robinson, Illinois; and Detroit, Michigan. These refineries ran a total of 511,000 barrels per day in 1996. Marathon is involved in wholesale and retail marketing of refined products. In 1996, the company had refined product sales of 704,000 barrels per day, which included 412,000 barrels per day of gasoline.

Marathon holds many federal and Indian leases both onshore and offshore. In the federal OCS 166 Lease Sale in March, Marathon and its bidding partners were awarded 11 blocks in 9 prospects in the Gulf of Mexico. These prospects increased Marathon's inventory of Gulf prospects to 50. In 1996, Marathon paid royalties of over $84 million for oil and natural gas produced from federal and Indian lands. In addition to the royalty paid in-cash, the Minerals Management Service (the "MMS") took crude oil valued at over $9 million in-kind through the small refiner royalty-in-kind program. The royalty-in-kind volumes were taken primarily from OCS leases and onshore leases in Wyoming and Colorado.

We are here today to discuss royalty-in-kind ("RIK") as an alternative method for satisfying the royalty obligations of producers with federal oil and gas leases. Royalty-in-kind is certainly not a new topic. The MMS has always had the option of taking its royalty in-kind as opposed to in-value. By fully exercising this option and marketing its royalty production, the MMS would eliminate valuation disputes with its lessees. Industry's interest in a comprehensive royalty-in-kind program and the certainty it would provide to federal lessees was demonstrated earlier this year. The public workshops held by the MMS this spring in Casper, Wyoming; Houston, Texas; New Orleans, Louisiana; and Farmington, New Mexico to discuss and review possible options for a major royalty-in-kind program were widely attended by all segments of the oil and gas industry. Marathon actively participated in these sessions and welcomed the opportunity to candidly discuss critical features of a workable RIK program. Royalty-in-kind was also a recurring theme in the testimony offered at the April 15 and 17, 1997 MMS public hearings on the January 24, 1997 Proposed Rulemaking on Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil. In published comments to the proposed federal rulemaking, royalty-in-kind was suggested, in some form, by almost all of the major oil and gas trade associations as an alternative to the proposed rulemaking. Royalty-in-kind is also supported by at least one of the consultants used by the MMS to develop the proposed oil valuation regulations. In a February 21, 1995 report to the State Lands Offices of Colorado, New Mexico, and Texas, Summit Resource Management, Inc. said, "The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in-kind for sale by the state agency."

Marathon applauds the MMS' decision earlier this year to conduct an in-depth reengineering of all core processes of the Royalty Management Program. Marathon, and the oil industry in general, has developed a great deal of expertise over the last ten years in reengineering business processes. Reengineering is the term used to describe fundamental changes to a process. It is not just rearranging steps, but rather evaluating each step, eliminating those which are not value added, and adding new steps, if necessary. At Marathon, we have learned that reengineering an entrenched process is not easy, but if all stakeholders are engaged in the process and it is done properly, the results can be significant. Many times the benefits are much greater than anticipated, because it is difficult to identify all the indirect benefits. As part of the MMS' reengineering effort, Marathon believes a RIK program can be created which will fundamentally add value to the MMS' royalty process. Royalty-in-kind is a concept whose time has come. The key is turning this opportunity into reality.

As discussed at the royalty-in-kind workshops, a comprehensive in-kind program need not be complicated. If the MMS were to take its royalty oil or gas in-kind at or near the point of production, the MMS would control the valuation of its share of the production, and a federal lessee would only be required to report production volumes. The MMS could take its royalty barrels at the point established by the Bureau of Land Management onshore, or the MMS offshore, for the measurement of volumes for royalty purposes. The MMS could then contract with a number of companies with marketing experience to act as the MMS' agents to aggregate and market the royalty oil or gas for optimal value.

By taking its royalty oil or gas in-kind, the MMS would experience three key benefits. First, the MMS would have the opportunity to optimize the value of its royalty oil and gas in the marketplace. Second, a royalty-in-kind program would alleviate the complexities and uncertainties of determining market value at the lease. When its royalty is taken in-kind, the market value is simply the price the MMS receives from a willing buyer. And third, the administrative burdens of both the MMS and the federal lessees, especially audit and litigation costs, would be reduced significantly or even eliminated.

A review of the current royalty payment process shows it is fraught with redundant steps and disputes over valuation. This process begins with the reporting of production volumes to the MMS. Another report is submitted to the MMS showing the volumes and values being paid by the lessee. The MMS then compares these reports and begins a cycle of checking and auditing the reports and payments. It is during this process that disputes between the MMS and the lessee arise. Although many disagreements over royalty payments are successfully resolved, they consume the time and resources of both the MMS and industry. Almost all of the lengthy disputes and lawsuits are over valuation issues; very few concern volume discrepancies.

If the MMS would take its royalty share of production in-kind, at or near the wellhead, the valuation review and audit cycle would virtually be eliminated. By selling its royalty share of production, the MMS would be assured of a price it agrees to for a particular lease. A streamlined process could be created where only a volume report would be sent to the MMS. Certainly, the MMS would have to verify the volumes, but that is a rather straightforward process. The administrative savings achieved by reducing the audit function and the expense of litigation would be one avenue of revenue enhancement.

The second channel of revenue enhancement is the MMS' opportunity to aggregate volumes, determine the most favorable sales locations, arrange transportation, and negotiate the terms and conditions of the sale of its royalty production. Participation in these activities can result in optimized value if the MMS is willing to manage the risks and incur the costs associated with the marketing function. Expertise of a competitive private marketer would allow the MMS to participate in the described activities in the most efficient manner possible and thus achieve the greatest possible revenue benefits.

During the last several weeks, a multi-association task force has been formed to develop a workable federal royalty-in-kind program. This group is comprised of representatives from over a dozen oil and gas trade associations, including the American Petroleum Institute ("API"), Independent Petroleum Association of America ("IPAA"), Rocky Mountain Oil & Gas Association ("RMOGA"), Domestic Petroleum Council ("DPC"), Independent Petroleum Association of Mountain States ("IPAMS") and Mid-Continent Oil & Gas Association ("MOGA"). Marathon is an active participant in this task force through its membership in API. The efforts of this task force are important to Marathon for two reasons. First, Marathon would welcome the certainty of knowing its royalty obligation was fulfilled once the royalty barrels were delivered to the MMS. And second, Marathon recognizes that expertise in all segments of the oil and gas business will be necessary to develop a federal royalty-in-kind program that is viable and workable. The multi-association task force is a means to effectively utilize the expertise and resources of a wide variety of oil and gas companies in developing a federal RIK program.

Marathon believes this multi-association task force offers a great opportunity to develop a meaningful, well conceived RIK program which addresses the major concerns of all stakeholders. Essentially, this task force is embarking on a major reengineering initiative which is not inconsistent with the general reengineering goals of the MMS. It seems that the Subcommittee on Energy and Mineral Resources can benefit tremendously from the efforts of this task force. This process is not easy, but we feel it is vitally important in developing a successful RIK program.

The mission of the task force is "To design a federal royalty-in-kind ("RIK") program that will eliminate valuation uncertainty and that will be attractive to federal, state and private sector stakeholders while recognizing the differences between oil and gas production." To accomplish this purpose, the task force identified six principles which a royalty-in-kind program should encompass.

First, the program should reduce administrative and compliance burdens while providing the opportunity for federal and state governments to maximize revenues. The MMS and states should have the ability to optimize value by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. The potential for increased revenues will require the MMS to manage the risks and costs associated with marketing royalty oil and gas. Federal leases should not realize an increase in administrative costs or experience operational burdens, but have certainty through elimination of disputes associated with royalty valuation. Similar benefits will also accrue to the government. An effective RIK program should not impose upon lessees any costs or obligations beyond the lessee's obligation to deliver at or near the lease. Reporting should be related to volumes produced and delivered, not sales prices or other related valuation information. Also, marketers should be provided a business opportunity which has an acceptable risk/revenue ratio thereby enticing participation by the most professional and successful marketers in the business.

The second principle requires transactions at or near the lease that fulfill the lease obligations. RIK production must be delivered at or near the lease. The government must give sufficient notice and take for a certain minimum period of time. Once delivered at an RIK delivery point at or near the lease, the lessee's royalty obligation must be completely satisfied. A lessee has no duty to market or transport the government's oil or gas past this point. All risks and costs incurred downstream of the RIK delivery point should be borne by the lessor or its purchaser, in the hope of realizing maximum revenue from reselling the production downstream.

The purchaser who takes delivery at the RIK delivery point is actually taking from the government and performing under a separate contract. The lessee and the government's purchaser have no contractual relationship with each other. An effective RIK program should not hold the lessee liable for the purchaser's failure to perform under the RIK contract, nor should it hold the purchaser liable for the lessee's failure to perform under the lease contract.

The third principle provides that when the government elects to take in-kind it must take all royalty production for a time certain. If the government takes its royalty in-kind, it must give sufficient notice and for a time certain take the full royalty fraction tendered by the lessee(s) from a given property. The government has no right under the lease to defer its take obligation or leave its production in the ground. The government has no right under the lease to defer any production from either new or existing leases. Otherwise, lessees will be unfairly burdened by having additional marketing and operational problems with which to contend.

The fourth principle requires use of private marketing expertise to streamline government operations. The government's oil or gas should be marketed through a competitive, privatized system in order to maximize benefits and streamline government operations.

The fifth principle provides for states to have the opportunity to be involved in designing and implementing the program. At least one state, Wyoming, has been actively promoting the RIK concept this year. In addition to being actively involved in the design of a government RIK program, the states need to be given the opportunity to participate in the marketing of federal royalty stream taken in-kind. Any program should follow these principles.

Finally, the sixth principle makes royalty taken in-kind broadly available for public purchase. The purchase of hydrocarbons subject to this RIK program should be made available on an open competition basis to a broad-based public market. This should include providing the opportunity to market to a broad group of interested and qualified marketers.

An important step in designing a royalty-in-kind program is to look at an example of an existing RIK program. In November 1988, the General Land Office ("GLO") in Texas initiated a royalty-in kind program for oil, followed by The University of Texas System ("University") in 1990. Since 1988, the GLO has taken all of its royalty oil in-kind from the Marathon-operated Yates Field, one of the largest onshore oil fields in the United States. The Yates crude oil is gathered and transported from the lease to a central battery unit where custody transfer takes place. Currently, the GLO is taking over 2,000 barrels per day in-kind. Marathon also has experience with the University's RIK program as operator of the Big Lake Field.

Overall, Marathon's experience, with both Texas royalty-in-kind programs has been positive. The programs provide certainty for the in-kind barrels by satisfying Marathon's obligation to the lessor and eliminating protracted disputes over valuation issues for both Marathon and the lessors. Marathon firmly believes greater benefits could be recognized by both the state and Marathon if these royalty-in-kind programs were expanded. Furthermore, as an operator of four refineries and a net purchaser of crude oil, Marathon welcomes the opportunity to bid on the royalty barrels offered by the GLO and University.

One of the lessons learned from the Texas RIK programs is that any new comprehensive program is going to experience start-up problems. During the first year of the Texas programs, there were problems concerning which party was responsible for gathering costs, the arrangement and verification of transportation, and the proper allocation of production. For example, there was a dispute between the first purchaser of the GLO's Yates crude and Marathon regarding the delivery point of the oil and the 12½ cents per barrel gathering fee. The purchaser eventually paid the gathering tariff, but not until Marathon, as operator, expended a great amount of time and effort on the matter. Marathon would be remiss if it failed to acknowledge that this testimony might be much different if it were given in 1990. However, over time producers, purchasers, and the state have been able to work through these operational, transportation, marketing, administrative, and communication issues.

While not without imperfections, the royalty-in-kind programs in Texas are very workable, viable alternatives to royalty paid in-value, and Marathon believes a wide-scale royalty-in-kind program is also workable for federal lands. It is imperative to understand that adequate time must be allowed to overcome the initial hurdles of a royalty-in-kind program. There is no way to totally eliminate the learning curve. The MMS must recognize that the early stages of an RIK program or even a short duration pilot program can, and most likely will, provide misleading results. Only after the program has been in place for an extended period will meaningful results be obtainable. For this reason, the MMS must be very careful if it chooses to implement and evaluate any royalty-in-kind pilot program. In fact, Marathon believes it would be more prudent to expend the effort to develop a permanent royalty-in-kind program that could be phased in over time.

Madam Chairman, in your letter inviting me to testify in today's hearing, you asked that I comment on how a national program could increase revenue to the federal and state treasuries. A properly developed RIK program provides the federal government with the opportunity to not only achieve revenue neutrality, but also to increase net revenue. Both the MMS and industry generally agree that value can be added downstream of the lease by aggregating volumes, determining the most favorable sales location, arranging transportation, and negotiating the terms and conditions of the sale. In addition, a comprehensive RIK program will allow significant cost savings to the federal and state governments. However, Marathon realizes legislation may be needed to ensure that a comprehensive RIK program satisfies the requirements of the federal and state government as well as federal lessees.

Marathon is concerned that the impact of a royalty-in-kind program on the federal and state treasuries be analyzed properly. When the MMS decides to "check" on its progress, it must add cost savings from reduced overhead to revenue enhancement in order to determine the degree to which the program is a success. As illustrated by Marathon's experience with the RIK programs in Texas, any review or analysis during the first year can provide misleading information. Marathon believes this is the case with the MMS' review of the 1995 Royalty Gas Marketing Pilot Program. The MMS' analysis of this program concluded that royalties collected during the pilot were less than would have been collected if the MMS continued to collect the royalties in-value. However, like the Texas experience, Marathon believes the real benefits of a comprehensive federal RIK program can only be realized after sufficient opportunity to work through the initial problems. Unfortunately, the MMS' gas RIK pilot program did not allow sufficient time to work through the difficulties encountered. Moreover, the results of the gas RIK pilot program were far from dismal.

As previously indicated, Marathon participates in a number of industry associations, including API, which are concerned with royalty valuation issues. API recently completed an assessment of the MMS' review of its 1995 Royalty Gas Marketing Pilot Program conducted in 1995. The key points of API's study of the pilot program are:

- With such a limited test, it is statistically inappropriate to estimate revenue neutrality as a single number rather than as a range of possible values. If proper adjustments were made for uncertainty, the MMS could have found the pilot study was well within the expected range of revenue neutrality.

- As a result of the lessons learned from the pilot program by industry and the MMS, program modifications will enhance revenues in an expanded and permanent program. These lessons learned include those related to transportation arrangements, the packaging of gas taken in-kind into larger volumes, and further administrative cost savings.

- Finally, a more careful analysis of the longer run consequences of a well-designed program will likely find that revenues would be greater than what was estimated by the MMS. Proper recognition of the economic incentives resulting from risk reduction and administrative savings will encourage operators to extend the effective life of fields (thereby prolonging the stream of royalty payments) and increase lease bonus payments on new leases. These impacts were not accounted for by the MMS in its evaluation of the pilot program.

Attached to this testimony is the report prepared by the American Petroleum Institute. The concerns raised by the API must be addressed before any final conclusions are drawn regarding the budgetary impact of the gas royalty-in-kind pilot program. Furthermore, because neither API's approach nor that used by the MMS strictly follows congressional budget score-keeping procedures, another study has been initiated which will, in a more formal way, address the revenue effects of the pilot program using the required congressional budget scoring rules. This study will be available in the near future.
In summary, Marathon believes the time has come for the federal government and the oil and gas industry to seriously consider royalty-in-kind as the best long-term solution to satisfying the federal lessees' royalty obligation. A properly developed RIK program could streamline the royalty process for the federal and state governments and the oil and gas industry.

Marathon's participation in the multi-association task force is a clear indication that the company is committed to helping develop an RIK program that will satisfy the major concerns of all stakeholders. Marathon, along with many other federal lessees, is committed to working with this Committee and the MMS to develop a workable royalty-in-kind program. Working together we can minimize many of the start-up problems which may occur and shorten the learning curve for both the federal government and the lessees. A royalty in-kind program can be a win/win proposition for all parties involved.

79513.01

Comments on the MMS Royalty Gas Marketing Pilot Program

Background

The Department of Interior's Minerals Management Service (MMS) collects royalties on oil and natural gas produced on federal leases. Traditionally, these royalties have been based on the value of production, as measured by the companies. The MMS audits the valuation estimates made by companies and challenges the estimates when it believes errors have been made. The process is characterized by continual disputes and is costly, both for the MMS and for the producing companies who must document and defend their valuation estimates. For this reason, MMS has considered collecting its royalties in kind rather than in value. By taking title to its royalty share of natural gas (or oil) it could in principle directly capture the market value of its royalty share, thereby eliminating disputes concerning how its royalty share is valued by the companies. As a result, both the MMS and producing companies would save money and resources.

During 1995, the MMS conducted a pilot program in which it collected royalties in kind on natural gas production from a limited sample of offshore leases. MMS then sold its royalty share to private marketing firms which had bid on this gas. The aim of this pilot program was to assess the operational feasibility of collecting royalties in kind and, specifically, to determine whether MMS would lose revenues by changing to a revenue-in-kind (RIK) system. The pilot program proved to be operationally feasible. However, in its review of the program the MMS concluded it was a revenue loser. MMS estimated that its revenues were 6.5% less than would have been collected under the traditional valuation method.

To determine whether its pilot program was revenue neutral, the MMS first estimated the price in each month that it needed to receive on its royalty production so that revenues would have been equivalent to what MMS would have received under the royalty valuation system. For each month in 1995, MMS applied the year-to-year trend in prices of production from leases not included in the pilot program to its royalty production, using as a base the monthly 1994 prices. The monthly 1994 prices were first adjusted upward by 3% to reflect the historical impact (as estimated by MMS) of audits. In comparing the prices it actually received in each month to these estimated prices, MMS concluded that its revenue loss amounted to 6.5%.

This paper offers some comments on the MMS review of its pilot program and its finding that an RIK program would likely be a revenue loser. The conclusion to be drawn from these comments is that the option of collecting royalties in kind should not be rejected on the basis of this initial pilot program.

1. The benchmark used by MMS to determine whether its pilot program was revenue neutral was a point estimate of the revenues it would have collected under the traditional royalty valuation system. Given the uncertainties surrounding any forecast, it would have been more appropriate to forecast a range of revenues that would have been expected under the traditional royalty system .

Normal variability and noise in data result in deviations from any point estimate. Given the volatility of gas prices, the uncertainty surrounding the impact of future audits, and the limited (and nonrepresentative) sample of leases in the pilot, any forecast of the revenue neutral price is bound to be uncertain itself. This is why forecasts typically include confidence intervals around any point estimate. A confidence interval indicates the range of values which deviate from, but which, in the sense of statistical significance, might be fully consistent with the forecast. Thus, it is entirely possible that a deviation of ±6.5% from MMS' point estimate is statistically consistent with revenue neutrality. And, as discussed below, several improvements in the RIK pilot would have increased revenues and reduced the estimated deviation, thereby increasing the likelihood that the program was in fact revenue neutral.

2. The benchmark of revenue neutrality used by MMS is too narrowly defined and does not take into account the indirect impacts. A more broadly-defined benchmark might find that an RIK program yields more revenue than estimated by MMS.

To determine whether the revenue collected from an RIK program would be acceptable, the MMS limited its focus to the flow of revenues on an existing sample of leases. The "test" concerned whether, during this one-year period, revenues on these leases were equivalent to an estimate of what would have been received had the traditional valuation process been in place. But this test ignores both indirect and longer term impacts.

First, bonus bids for new leases would be higher under an RIK program since the administrative costs borne by lessees would be reduced. Reduced costs would increase the expected value of any lease and hence induce companies to bid more for the lease. Thus, the MMS would benefit from larger bonus bids.

Even on existing leases, an RIK program would lower administrative costs. Since these are a function of the level of production, incentives at the margin would be improved. Lessees would find it profitable to keep wells in production longer than they otherwise would have. Thus, over the lifetime of a well, additional revenues for the MMS would be generated. The potential for such revenue is not included in the MMS revenue impact assessment.

The converse of this argument also holds. If MMS were to increase its effective royalty rate, its revenue from existing operations would increase. However, because the market for leases is competitive, the negative impact of higher royalty rates on production would result in lower bonus bids on new leases. And, reduced profitability would shorten ultimate production from existing leases, and hence the long term flow of royalty revenue to MMS also would be reduced.

3. Transportation costs on gathering lines are not a barrier to revenue neutrality when the concept of revenue neutrality is properly defined.

A recurring theme in the assessment of the pilot program (by the MMS and by the Office of the Inspector General) is that transportation costs that private marketers must pay for transportation use of non-regulated gathering lines are a barrier to revenue neutrality. Under current regulations, gas producers who own gathering lines are limited to charging transportation rates which cover "actual costs" as defined by regulatory authorities. The MMS argues that if marketers must negotiate transportation rates with owners of gathering lines, then the amount they will bid will be accordingly reduced. Thus, the argument goes, MMS will receive less than it would under the current valuation system given that the transportation charge that gets deducted from the royalty value of its gas is regulated.

In part, the MMS seems to be saying that the pilot program worked in the sense that the firms which bid on its royalty gas were able to realize the true market value of the gas, but that the program was a revenue loser because regulatory treatment of transportation costs on some gathering lines provides the MMS with an advantage over private firms which must pay market rates for transportation. Removal of a regulatory advantage obviously would make it difficult for any RIK program to be revenue neutral, especially if the benchmark of revenue neutrality is limited to a consideration of year-to-year flows in royalty revenue. But this merely says that the source of revenue loss to MMS is attributable to the removal of a regulatory advantage, not that marketers are incapable of realizing the market value of natural gas.

More fundamentally, if the concept of revenue neutrality is expanded (as discussed above) so that it includes revenues received from producers from bonus bids and lifetime production, then higher transportation costs do not necessarily result in reduced revenues. If gas producers who own gathering lines find that they can charge more for transportation for the royalty portion of their gas, they will be induced to bid more for new leases. And, to the extent the profitability of production from existing leases is increased because owners can charge more for royalty gas transportation, they will have an incentive to extend the life of the well, thereby prolonging the flow of royalty payments to MMS.

4. Larger gas packages would increase MMS revenues.

In a review of the MMS pilot program, the Interior Department's Office of the Inspector General identified a number of changes that would have increased the flow of revenues. Perhaps the most important was the proposal to package gas volumes in larger sizes. The review found a direct correlation between bid prices and gas volumes. In fact, on the four bid groups which contained over 10,000 MMBtu per day, bid prices were almost 6 cents higher than the overall average bid. The average package contained about 4,800 MMBtu per day.

To put this in perspective, recall that MMS estimated its loss at $0.0974 per MMBtu. The estimated percentage revenue loss was 6.5%, implying an average base price of $1.4985 per MMBtu. If larger packaging could have reduced this loss by $0.06, the adjusted reduction in price (=$0.0374) would have been just 2.5% under the revenue neutral base price. Obviously, the four bid groups comprising larger volumes do not make up a statistically significant sample. Nonetheless, the evidence suggests that this one change alone might go a long way toward making an RIK program revenue neutral, even when the concept of revenue neutrality is narrowly defined.

5. The sample of leases in the pilot program was not representative of overall gas operations and the estimate of the revenue neutral price may be biased upward.

Another potential problem with the pilot program is that the leases included in the pilot program were not representative of overall gas operations in the Gulf of Mexico. The leases were volunteered rather than selected at random. A basic rule in any sampling procedure is to select at random. Volunteers for a test may have a different set of incentives than the universe being sampled and hence the results can be biased.

Another indication that the leases in the pilot were not representative is the fact that the January 1994 price received for gas not included in the pilot averaged $2.139 per MMBtu whereas the price received for gas which subsequently was included in the pilot was just $2.063 (even after increasing the actual price upward by 3% to adjust for the assumed impact of future audits).

If gas which is valued less highly is susceptible to more volatile price movements, then the fact that average gas prices fell by 22.6% between 1994 and 1995 means that the price for gas production that was part of the pilot program would have declined more than 22.6%. In such a case, the MMS estimate of what constitutes the revenue neutral price for 1995 is too high. In turn, this means that the price actually paid was closer to being what the MMS would have received under the current valuation system. Thus, this factor also might have caused the pilot program to be more revenue neutral than MMS believes.

6. Administrative cost savings could well be larger than what is estimated by MMS.

There is every reason to believe that the government administrative cost savings from a permanent and all-inclusive RIK program are larger than what is projected by MMS. The full impact of regulatory change can take a considerable period of time as regulated entities eventually find new, more efficient practices. Estimating administrative cost savings by simply assuming that fewer employees are required does capture the potential gains from new practices. At a minimum, an independent assessment of potential savings is required. Such an assessment should provide a range of potential savings rather than a point estimate.

7. Changes in a new pilot RIK program would further contribute to revenue neutrality.

The Department of Interior's Office of Inspector General identified several other changes that should result in increased revenues for MMS. The review by this office found that the lack of guaranteed gas volumes in the original pilot resulted in lower bid prices. By withholding some gas, the MMS could develop a reserve to cover unexpected reductions in production. Such reductions make it more costly for marketers to cover their commitments and hence they bid less than they would if they knew they could draw on this reserve gas supply. In addition, many of the participants argued that allowing a longer period to formulate bids would result in higher bids as those bidding would have more time to gather information.

Finally, MMS could experiment with different bidding procedures. For example, it could try a two-round bidding process whereby the top three or so bidders have the opportunity to submit their best and final offer. This might result in higher prices.

DN: worddocs\mmspilot; 7-23-97

For the record I would like to indicate that several associations wish to endorse my written comments; including :

Rocky Mountain Oil and Gas Association	RMOGA
National Ocean Industries Association	NOIA
Independent Petroleum Association of America	IPAA

Written statement by
Sue Ann Hamm
Vice President, Crude Oil Marketing
Continental Resources, Inc.
Representing
Independent Petroleum Association of America (IPAA)
Oklahoma Independent Producers Association (OIPA)
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Resources
July 31, 1997

Dear Madam Chairwoman and Members of the Committee:

I am Sue Ann Hamm, vice president of Crude Oil Marketing for Continental Resources Inc. (Continental), a privately held, independent producer who has federal onshore production. I am here today on behalf of Continental, IPAA and OIPA.

Continental is an exploration company. We have under contract eight or more rigs year round, drilling about 80 wells a year. Our exploration budget for 1996 was over $50,000,000 and is even greater for 1997. Most of the wells we drill are in the Rockies, and are what is known as horizontal wells. They are drilled to a vertical depth of 8,500, and then to a horizontal depth of 8,000 feet. We are able to do this through the availability of new technology, which allows us to drill areas which formerly did not have an acceptable rate of return. This opportunity also exists for the federal government and states.

Two years ago I began the crude oil marketing department for Continental. I have also built and managed gas marketing departments for two different companies. I have found that taking an active part in marketing our production can create a greater return than sitting back and accepting offers given us. By assuming downstream costs and risks, one can create higher prices.

In marketing our oil, I look for the highest net return. In the past, we sold our oil at the wellhead. I have found that our company is able to realize a higher average price per barrel by making all the transportation arrangements, exchanges and then final sales to refineries. We have even built our own gathering systems where we found this to lower our transportation costs. When we first began to take our marketing efforts downstream, we encountered a great deal more risks and costs than we had anticipated. However, over the long run, we have been able to realize a higher net price for our oil. We have a number of ways to measure this. Because we are in the market, we know the price others are presently receiving for like production.

When reviewing wellhead prices, we realized that with the greater risks, and by accepting marketing costs, we might be able to realize greater rewards. We were willing to take those risks. We hired a marketing consultant. He helped us move downstream in our marketing efforts. He advised us on the systems we needed in place to handle the sales each month. Scheduling and sellling the correct volume for the following month still remains a challenge. It is very difficult to predict for future months the volume which will be produced and delivered into pipeines and trucks. There is always a deviation from the actual production volume. However, since we began to build inventory in the pipelines on which we transport, we have been able to deal with swing volumes much more efficiently, and with less cost.

As we have became more sophisticated in our marketing efforts, we began to take in kind the oil and gas from our outside operated interests. This is somewhat analogous to the situation MMS would be in where it would take its royalty production from wells which it did not operate. It is more difficult to set up taking in kind production from a well we do not operate. If the well is not very prolific.

To determine whether it is economical for us to take in kind our production, we look to a number of factors. The first is what the transportation costs are to get the production to a market center. The second is what the prices are downstream . The third is what price/prices will purchasers offer to take the production at the wellhead. The fourth is what price are we receiving through the operator. One factor we do not even consider is what price is the operator receiving through his contract and are we receiving all of that. We do not consider audits a value enhancing measure. It is more like a dollar chasing a quarter. After we consider all the factors, we choose the method through which we will receive the highest price. Sometimes we simply opt to let the operator continue marketing the production for us, and paying us our proportionate share of the revenue they receive. Other times we take it in kind. These are very simple economics.

We produce approximately fifteen thousand barrels a day of oil. This is 6.86% of MMS's royalty volume. We produce 75,000 mcf of gas per day. This is 2.92% of MMS's royalty gas. Of this total production, less than 200 equivalent barrels per day of oil are federal royalty barrels. Obviously this is a negligible amount for us.

The question then, is, why are we even interested in the issue of federal royalty production if, "we do not have a dog in this fight". We prefer to take the broader view, as Madam Chairwoman has recommended. This is to stay involved, even on issues which do not presently affect us. MMS does not operate in a bubble. There is a ripple effect as a result of any of their actions. If there actions are inequitable, then this will necessarily have a negative impact on the entire domestic oil industry. This concerns us.

The present situation between MMS and the oil and gas industry has to be one of the most adversarial relationships of any agency and its related industry in the United States. It has become so much so, that many companies do not allow their executives to speak with an MMS representative without a lawyer by his side. This must be changed. The domestic oil and gas industry cannot survive with this extremely aggressive government supervision and oversight. Recognizing this, our company looked to an alternative which could refocus MMS' efforts from one of taking reactive measures, to one of taking proactive measures. This is how we run our business. It should also be so with the government's mineral revenue management.

Because our exploration efforts were extending into the northernmost parts of the United States, we began to look at Canada as our next frontier. To learn of any potential problems we might encounter with oil pricing and marketing, I took a trip to Calgary to become acquainted with the Canadian producers and learn about their oil marketing methods. Knowing that the Crown owned a great part of Canada, I was concerned about the problems associated with working with the government, and paying for its royalty share of production. This, of course, assuming we would be successful in our exploration efforts. We wanted our only risk to be exploring for oil. We did not intend to assume the risk of pricing the government's royalty production. The companies I met assured me that marketing the Crown's oil was not a problem. An act had been passed which required the government's agency, Alberta Energy, to take the Crown's oil in kind. The act is titled "Petroleum Marketing Act". Through this, the producer was relieved of any further liability once he delivers the production to the Crown's representative. Alberta Energy is required to take its oil in kind, and is given broad powers regarding marketing the oil. A copy of this act is attached.

To further explore the impact of this act, I met with representatives of the crude oil marketing department for a Canadian producer. They are a large producer and one of three contracting agents for the Crown's royalty oil. We discussed the various aspects of their arrangement with Alberta Energy. They found the contract to be financially rewarding for a number of reasons. Because they were already marketing their own oil, they had the expertise and the systems in place to take on and market additional oil. Any additional oil to market enjoyed their economies of scale. The five cent marketing fee paid by Alberta Energy covered any additional cost to market the Crown's oil, and provided an acceptable return. Once their contract expires, they indicated they intend to place a bid once again.

Several of the employees with the Canadian producer's marketing department had worked for Alberta Energy prior to its privatization of crude oil marketing. They had been able to bring to the producer their knowledge of the agency's production and procedures. It was suggested I speak with Don Olineck, the director of crude oil marketing for Alberta Energy. I met with Don and found him to be very knowledgeable of crude oil marketing, and a true systems expert for the aggregating and tracking of the Crown's royalty production. He created the system within Alberta Energy which aggregates and traces the oil to the point where revenue is received. This system is so efficient that it utilizes only 33 employees for the management of 146,000 barrels of oil per day. This is in comparison to MMS's approximately 1800 employees managing the revenue from 204,000 barrels of oil per day and 2,565,636 mcf per day. It must be pointed out, however, that of these 1800 employees, a number are involved in leasing offshore activities. Obviously, Alberta Energy has a more efficient method for managing its royalty revenue. Even if the two methods, ours and Alberta's, are revenue neutral, there would be tremendous cost savings by using Alberta's, this would result in higher net payment for all the recipients of federal royalty production revenue.

Don Olineck assured me that Alberta Energy is very pleased with its method of oil marketing. It is simple and certain. Simple in the fact that a minimum number of employees are required to administer the program, and certain in the fact that it is receiving the market price for its oil.

Can this royalty in kind program work for the U.S.? It most certainly can. Canada's royalty in kind program fulfills all the principles agreed to by the industry royalty in kind workgroup of which I am a participant. As a producer and marketer, I know that it is workable in the U.S. After speaking with Don Olineck, I know that it is workable from the government's perspective.

Arguments have been raised that there is no comparison between Alberta's oil production and MMS's production. I must differ with these arguments. There are great similarities. The volumes are similar. MMS manages 204,000 barrels a day, compared to Alberta Energy's 146,000. Geographic diversity is similar. All of Alberta's is, of course, in Alberta, a province much smaller than the U.S. However, 77% of MMS's volume is in the Gulf of Mexico, a geographic area much smaller than Alberta. The number of different producing leases is similar. MMS has 70,000 held by production leases, 25,000 of which are active. This is compared to Alberta's 63,000 held by production leases, 30,000 of which are active. Finally, the number of operators is not all that great a difference. MMS has 2,000 producing operators while Alberta has 500.

As you can see, the differences between the two countries' production is not all that great. However, as pointed out earlier, the difference in the methods is night and day, with dramatic differences in the number of employees. My point is not that Alberta Energy has better employees. The point is that Alberta Energy employees have a better, more efficient system to work with.

Even with all MMS employees, the perception of some is that MMS is not receiving the market price for its production. The solution is not to write and implement more complex and controversial rules in the valuation of oil and gas, rules that force wellhead producers to use downstream values at no cost to the lessor. This would only add more employees, and would not necessarily result in any higher price. The MMS needs to consider RIK--RIK the Alberta way.

To follow the Alberta program, MMS would have to take its production at the wellhead. There, the operator would deliver to MMS's designated representative the royalty volume. The operator would continue to deliver to his own purchaser his share of the volume. The only difference from the operator's current methods would be to carve out the royalty share of volume, as opposed to the royalty share of value. By carving out the royalty share of volume, a number of accounting steps would be eliminated for the operator. This should make the program attractive to operators.

After taking delivery at the wellhead, MMS's representative would have to negotiate the necessary transportation and exchanges to a market center, or to an individual purchaser. From there, the representative would determine whether the price is higher at the market center, or whether it needs to transport or exchange to another market center, or enduser. As a producer and marketer, we have to arrange and pay for a number of transportation routes and exchanges, and we do this for approximately 1,000 leases. We do this with two employees. MMS's representatives would have to do this for up to 25,000 leases. This is possible. The set up cost would be high. But no higher than paying salaries and overhead for ten times too many employees as is the current situation.

Don Olineck has offered to assist in any way necessary to help MMS set up this program. Industry is also a good source for MMS to utilize. In order to stay in business in the current oil and gas environment, companies must maximize their revenue and minimize their costs. We are experts at this. As stated before, our company cannot afford to spend a dollar chasing a quarter. Neither should MMS. Let us help MMS develop their program.

I am a member of the industry RIK workgroup. We have come a long way in agreeing to the principles of an RIK program. There are still some design issues to resolve. Transportation is a big issue. MMS representatives have stated on numerous occasions that transportation is a big hurdle. Maybe so. It can be overcome. We need some input from MMS. What is their comfort zone for transportation rates on pipelines? For regulated pipelines, is it a FERC approved rate? For unregulated pipelines, is it whatever the market will bear? Or is it some predetermined rate? A number of solutions have been discussed. None have been agreed upon. There is a solution. We can find it if we all work together on this one.

Another issue which has been agreed upon is to give the states the right to take their share of the production in kind. It is realized that this may have to be done legislatively. This would be to guarantee the states the full right to take their production in kind. Industry is in full support of this. The only condition is that the entire federal royalty stream be taken, be it by the federal government, state government, or both. Another item agreed upon was that all the states need to adhere to common principles for any state taking its royalty in kind. IOGCC could be designated as the body to organize this.

Obviously the present royalty system is not working. There is no reason to believe more rules can fix it. MMS cannot hire enough auditors to assure it that it is receiving true market value. A pilot project has been suggested by MMS. They are apparently apprehensive about taking all their royalty in kind. Why? If they are afraid it will fail if they take it all on at once, then I offer the following suggestion. Begin now developing and designing the system, a system for success. There is enough expertise out there to build a program that works, if given the appropriate time and attention. Have a goal of a year from now to begin an in-kind program, if all parties can agree to an appropriate design. This is a large undertaking. It is not insurmountable. We, industry, do it all the time. We can help.

It has been questioned whether it would be possible for MMS to take its oil in kind from leases which have no pipeline connection and are trucked. Yes, it is possible. MMS's representative could contract with the current trucking company to haul MMS's oil also. The trucking company would then deliver the oil into the same pipeline it was already using, giving MMS credit for its volume. MMS's representative would take the oil from there. With some production, MMS's representative will, out of economic necessity, use the current transporter of production, whether it is oil or gas, or trucked or piped. In this manner, MMS is bound by economics the same as any other nonoperating interest.

A technical issue involves MMS's representative scheduling and selling the correct volume for the following month. All marketers have to deal with this uncertainty. MMS would have to build inventory on the pipelines which its production is transported. These volumes could be used as swing volumes for any shortages of MMS production. This costs money, however. Sometimes as much as fifteen days production. This is only one of the costs which MMS must incur in order to take advantage of downstream marketing opportunities.

A final issue which needs to be resolved is whether MMS or the private sector will perform the marketing functions. This answer is easy. MMS should competitively bid out the marketing function of its royalty to the private sector. This solution has industry support. MMS would take custody of its royalty volume at the wellhead and could then turn the production over to its representative. Criteria for determination of the successful bidders who become MMS representatives is yet to be developed. Once again, we look to Alberta's criteria for choosing the successful bidder. Following Alberta Energy's scenario, the bidder, if chosen, commingles MMS royalty production with its own at the market center. The chosen bidder shares with MMS its proportionate share of all revenue, less actual costs, on the final sale of the commingled production. MMS would have the full right to audit this marketer. It would also receive copies of all contracts regarding production sales or exchanges. The marketing arrangements would be totally transparent for MMS to follow. In return, the marketer would be paid a marketing fee. MMS would narrow its number of operators to audit from 2,000 down to a fraction of this number. The number would be determined by the way production is divided geographically, type (oil or gas), and quality. MMS should have no shortage of bidders to market its oil. The MMS opportunities for net increases in revenues could be tremendous after costs and risks. Potential exists due to aggregating of large volumes and downstreaming marketing activities.

In the past, MMS has attempted a pilot RIK project. According to MMS, this has been a failure. From what I have learned of these projects, MMS did nothing more than offer to parties the royalty production at the wellhead. MMS wanted a sure price right then. This is called hedging. Sometimes you win, sometimes you lose. It depends on which way the market goes.

This type RIK is not what we are proposing. This project was doomed to failure for other reasons also. MMS unintentionally restricted bidding through design flaws. Simple economics show the more buyers there are, the higher the price. MMS took none of the downstream risks. Accordingly, it received none of the downstream opportunities.

The industry RIK workgroup is preparing a list of design guidelines to implementing an RIK program. This list will be submitted to the Subcommittee, hopefully within ninety days. For a number of reasons, the guidelines should be carefully considered. The vast knowledge and marketing expertise which is behind the preparation of the guideline is of great value to the government. The guideline report includes state involvement and has IOGCC support. It will have industry support. With our help, RIK will work.

Please accept my offer to help, as well as IPAA's and OIPA's, in any way possible, in attempting to design and advance an RIK program for Federal royalty production.

Statement for the Record
Sue Ann Hamm
Continental Resources, Inc.
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
July 31, 1997

Independent Petroleum Association of America
Oklahoma Independent Petroleum Association
Rocky Mountain Oil and Gas Association

PROVINCE OF ALBERTA

PETROLEUM MARKETING ACT

Revised Statutes of Alberta 1980, Chapter P-5
with amendments in force as of May 1, 1996

Consolidated June 27, 1996

OFFICE CONSOLIDATION

Queen's Printer Bookstore
11510 Kingsway
Edmonton, T5G 2Y5
427-4952
FAX 452-0668
On-line 422-1456

Queen's Printer Bookstore
Main Floor, McDougall Centre
455 - 6th Street S.W.
Calgary, T2P 4E8
297-6251
FAX 297-8450

NOTE

All persons making use of this consolidation are reminded that it has no legislative sanction, that the amendments have been embodied for convenience of reference only, and that the original Acts should be consulted for all purposes of interpreting and applying the law.

PETROLEUM MARKETING ACT

CHAPTER P-5

Table of Contents

Definitions	1

Part 1
Alberta Petroleum Marketing Commission

Alberta Petroleum Marketing Commission	2
Commission meetings	3
Offices	4
By-laws	5
Officers and employees	6
Delegation	6.1
Commission as Crown agent	7
Pensions	8
Fiscal year	9
Auditor	10
Annual report	11
Financing	12
General powers	13

Part 2
Marketing of the Crown's Royalty Share of Crude Oil

Definitions	14
Marketing of Crown's royalty share	15
Direction to transmit or store crude oil	16
Disposition of sales proceeds	17
Discharge and reporting	18
Regulations	19

HER MAJESTY, by and with the advice and consent of the Legislative Assembly of Alberta, enacts as follows:

Definitions

1 In this Act,

(a) "Commission" means the Alberta Petroleum Marketing Commission;

(b) "Department" means the Department of Energy;

(c) "Minister" means the Minister of Energy;

(d) "pentanes plus" means pentanes plus as defined in regulations under the *Mines and Minerals Act* respecting royalty.

RSA 1980 cP-5 s1;1983 c40 s2;1986 cD-18.1 s14

PART 1

ALBERTA PETROLEUM MARKETING COMMISSION

Alberta Petroleum Marketing Commission

2(1) There is hereby created a corporation with the name "Alberta Petroleum Marketing Commission" which shall consist of not more than 3 members appointed by the Lieutenant Governor in Council.

(2) The Lieutenant Governor in Council

(a) shall designate one of the members of the Commission as chairman and another as vice-chairman;

(b) may prescribe the term of office of any member or the term of office of the chairman or vice-chairman;

(c) shall prescribe the rates of remuneration to be paid by the Commission to the members of the Commission.

(3) The members of the Commission shall be paid by the Commission their reasonable travelling and living expenses while absent from their ordinary place of residence and in the course of their duties as members of the Commission, in accordance with the by-laws of the Commission.

(4) The vice-chairman of the Commission shall exercise and perform the powers and duties of the chairman in the event of the absence or inability to act of the chairman or a vacancy in the office of chairman.

RSA 1980 cP-5 s2;1995 c13 s5

Commission meetings

3(1) Subject to subsection (2), a majority of the members of the Commission constitutes a quorum at a meeting of the Commission.

(2) If one or 2 vacancies occur in the membership of the Commission the remaining members or member, as the case may be, may exercise all the powers of the Commission.

(3) At its meetings, the Commission may exercise any of its powers by resolution except when some other mode of exercising the power is prescribed in this or any other Act.

RSA 1980 cP-5 s3;1995 c13 s5

Offices

4(1) The head office of the Commission shall be at a place in Alberta designated by the Lieutenant Governor in Council.

(2) The Commission may establish any other offices and agencies it considers expedient.

RSA 1980 cP-5 s4

By-laws

5(1) The Commission may make by-laws respecting the calling of meetings of the Commission and the conduct of business at them, the duties and conduct of members and generally as to the conduct of the business and affairs of the Commission.

(2) The *Regulations Act* applies to by-laws of the Commission.

RSA 1980 cP-5 s5

Officers and employees

6(1) The Commission may appoint any officers and employees it considers necessary and prescribe their duties and their salaries or remuneration.

(2) The Commission may obtain the services of any agents or advisers or persons providing technical or professional services of a kind required by the Commission in connection with its business and affairs.

RSA 1980 cP-5 s6

Delegation

6.1 The Commission may in writing delegate any power, duty or function conferred or imposed on it by this Act or any other Act or any regulation to any person.

1995 c13 s5

Commission as Crown agent

7(1) The Commission is for all purposes an agent of the Crown in right of Alberta and its powers may be exercised only as an agent of the Crown in right of Alberta.

(2) An action or other legal proceeding in respect of any right or obligation acquired or incurred by the Commission on behalf of the Crown in right of Alberta, whether in its name or in the name of the Crown in right of Alberta, may be brought or taken by or against the Commission, in the name of the Commission, in any court that would have jurisdiction if the Commission were not an agent of the Crown.

RSA 1980 cP-5 s7

8 Repealed 1984 cP-35.1 s51.

Fiscal year

9 The fiscal year of the Commission is the calendar year, unless otherwise prescribed by the Lieutenant Governor in Council.

RSA 1980 cP-5 s9

Auditor

10 The Auditor General is the auditor of the Commission.
RSA 1980 cP-5 s10

Annual report

11(1) The Commission shall annually, after the end of its fiscal year, prepare a general report summarizing its transactions and affairs during its last fiscal year and showing the revenues and expenditures during that period, an audited balance sheet and any other information that the Lieutenant Governor in Council may require.

(2) When the report is prepared, the Minister shall lay a copy of it before the Legislative Assembly if it is then sitting and if not, within 15 days of the commencement of the next ensuing sitting.
RSA 1980 cP-5 s11

Financing

12(1) The Provincial Treasurer shall pay to the Commission the money voted by the Legislature for the purposes of the Commission in equal monthly instalments unless otherwise agreed between the Commission and the Provincial Treasurer.

(2) If the money voted by the Legislature for the purposes of the Commission is not sufficient for the Commission to meet its obligations as they become due, the Lieutenant Governor in Council may authorize the Provincial Treasurer to make payments to the Commission from the General Revenue Fund.

(3) The Commission, with the approval of the Minister and to the extent permitted by the Minister,

(a) may from time to time borrow money from any person or enter into overdraft arrangements with a bank or treasury branch, for the purpose of meeting its obligations as they become due, and

(b) may give security for the repayment of that money.

(4) The Lieutenant Governor in Council may authorize the Provincial Treasurer to guarantee on behalf of the Crown in right of Alberta the repayment of any money borrowed by the Commission pursuant to subsection (3) and interest on that money.

(5) After the end of each fiscal year of the Commission, the Commission shall, when requested to do so by the Provincial Treasurer and in accordance with his directions, pay to the Provincial Treasurer for deposit in the General Revenue Fund the net profit of the Commission for the preceding fiscal year or the part of that net profit specified by the Provincial Treasurer.
RSA 1980 cP-5 s12;1986 c29 s2

General powers

13(1) The Commission has the capacity and, subject to this Act, the rights, powers and privileges of a natural person.

(2) The Commission, in the conduct of its business and affairs, may exercise its rights, powers and privileges in the course of

(a) carrying on the business of acquiring, selling and exchanging crude oil, condensate and synthetic crude oil and products of any of them and engaging in activities related or incidental to that business,

(b) exercising and performing its functions under this or any other enactment, and

(c) acting in any other circumstances as an agent of the Crown in right of Alberta.

RSA 1980 cP-5 s13;1986 c29 s2;1992 c28 s2

PART 2

MARKETING OF THE CROWN'S ROYALTY SHARE OF CRUDE OIL

Definitions

14 In this Part,

(a) "agreement" means a lease, licence, permit or reservation of petroleum and natural gas rights or petroleum rights issued pursuant to the *Mines and Minerals Act* or its predecessors and to which section 117 of the *Mines and Minerals Act* applies;

(a.1) "crude oil" means the crude oil component of petroleum;

(b) "lessee" means the holder of an agreement according to the records of the Department.

RSA 1980 cP-5 s14;1986 c29 s2

Marketing of Crown's royalty share

15(1) Subject to the regulations, the Commission

(a) shall accept delivery within Alberta of the Crown's royalty share of the crude oil recovered pursuant to an agreement and required to be delivered to it by section 117 of the *Mines and Minerals Act*, and

(b) shall sell the Crown's royalty share of crude oil at a price that is in the public interest of Alberta.

(2) Repealed 1992 c28 s3.

RSA 1980 cP-5 s15;1986 c29 s2;1992 c28 s3

Direction to transmit or store crude oil

16(1) When the Commission wishes to arrange for the storage of crude oil delivered to it pursuant to section 15, the Commission may

(a) direct the operator of a pipeline to transmit the crude oil by his pipeline to a storage facility in Alberta designated by the Commission or to a point in Alberta designated by the Commission that is enroute to a storage facility, or

(b) subject to subsection (2), direct the owner of any storage facility in Alberta to accept the crude oil for storage and to store it in that storage facility,

subject to the payment of compensation for it by the Commission in accordance with subsection (3) or (4).

(2) The Commission shall not make a direction under subsection (1)(b) in respect of a storage facility consisting of an underground formation unless an approval has been previously obtained from the Energy Resources Conservation Board pursuant to section 26(1)(d) of the *Oil and Gas Conservation Act*.

(3) When a direction is made by the Commission under subsection (1)(a) and the Commission is unable to reach an agreement with the owner or operator of the pipeline as to the just and reasonable charges to be paid by the Commission for the transmission of the crude oil by that pipeline, section 101 of the *Public Utilities Board Act* applies.

(4) When a direction is made by the Commission under subsection (1)(b) and the Commission is unable to reach an agreement with the owner or operator of the storage facility as to the just and reasonable charges to be paid by the Commission for the storage of the crude oil, the Public Utilities Board may, on the application of the Commission or the other party to the dispute, fix those storage charges.

(5) A person who does not comply with a direction given to him by the Commission under subsection (1) is guilty of an offence and liable to a fine not exceeding $5000 for each day that the failure of compliance continues.

(6) If a person does not comply with a direction given to him by the Commission under subsection (1), then, whether or not he has been convicted of an offence under subsection (5), the Commission may by originating notice apply to the Court of Queen's Bench for an order requiring that person to comply with the direction.

RSA 1980 cP-5 s16;1986 c29 s2;1992 c28 s4

Disposition of sales proceeds

17 The Commission shall pay the proceeds of sales of crude oil by it under this Part to the Provincial Treasurer for deposit in the General Revenue Fund in accordance with the directions of the Provincial Treasurer.

RSA 1980 cP-5 s17;1986 c29 s2

Discharge and reporting

18(1) Subject to this section, the delivery to the Commission of the Crown's royalty share of crude oil recovered pursuant to an agreement operates to discharge the lessee with respect to his liability to pay that royalty to the Crown in right of Alberta.

(2) The Lieutenant Governor in Council may make regulations

(a) respecting information to be furnished to the Commission, the persons required to furnish that information, the form in which that information must be furnished and the time within which the information must be furnished;

(b) respecting the imposition of pecuniary penalties payable to the Commission, the circumstances in which the penalties may be imposed, the persons liable to pay the penalties and the time by which the penalties must be paid;

(c) respecting the respective rights, powers, liabilities and obligations of the Commission, lessees and others in the event that the quantity of crude oil delivered to the Commission under this Part in a month is less than or greater than the Crown's royalty share of the crude oil actually payable in respect of that month.

(3) Without limiting the powers of the Lieutenant Governor in Council under subsection (2)(c), regulations may be made under that clause

(a) respecting the powers of the Commission, in the event of a deficiency in deliveries of the quantity of the Crown's royalty share of crude oil under an agreement in a month, notwithstanding section 117 of the *Mines and Minerals Act*,

(i) to accept the payment of money in lieu of delivery of the deficient quantity, or

(ii) to direct the payment to the Commission of an amount of money determined by it in accordance with the regulations as the value to the Crown of the deficient quantity;

(b) respecting the powers of the Commission, in the event of deliveries of crude oil to the Commission in a month in excess of the quantity of the Crown's royalty share of crude oil for that month, to act as the agent of the owner of the excess quantity for the sale and delivery of the excess quantity to a purchaser in accordance with the regulations.

(4) Where money is paid to the Commission pursuant to regulations under subsection (3)(a),

(a) the money shall be deemed to be payable under an agreement and to be proceeds from the sale of crude oil for the purposes of section 17 and shall for all other purposes be deemed to be a money royalty payable on crude oil under an agreement, and

(b) the payment of the money operates to discharge the lessee of an agreement with respect to the lessee's liability to pay royalty on crude oil to the Crown in right of Alberta to the extent that the money represents the value of the royalty on crude oil as determined under the regulations.

(5) A failure to comply with the regulations under this section in respect of an agreement shall, for the purposes of section 44(1)(c)(i) of the *Mines and Minerals Act*, be deemed to be a failure to comply with that Act in relation to the agreement.

(6) Reports and other information supplied to the Commission pursuant to regulations under this section shall, for the purposes of section 39 of the *Mines and Minerals Act*, be deemed to be supplied under that Act.

RSA 1980 cP-5 s18;1983 c40 s5;1986 c29 s2;1988 c19 s4; 1992 c28 s5;1996 c16 s3

Regulations

19 The Lieutenant Governor in Council may make regulations providing for any matter in connection with or incidental to the administration of this Part.

RSA 1980 cP-5 s19

Parts 3, 4 and 5 Repealed 1986 c29 s2.

Edmund P. Segner, III

Executive Vice President & Chief of Staff

Enron Corp.

I am Edmund P. Segner, III, executive vice president and chief of staff of Enron Corp., a diversified energy company headquartered in Houston, Texas, with assets of $19 billion and operations in 19 countries. As a major participant in the upstream, midstream and downstream domestic energy markets, Enron has a direct interest in the proposed royalty-in-kind program for federal oil and gas production as both a marketer of oil and gas and as a producer. Enron Capital & Trade Resources (ECT), a wholly owned subsidiary of Enron Corp., is one of the largest purchasers and marketers of natural gas and the largest wholesale marketer of electricity in the country. ECT actively purchases gas produced from federal lands and offers marketing and risk-management services to public and private entities.

I am also a director of Enron Oil & Gas Company (EOG), a majority-owned affiliate of Enron, that explores for oil and gas in the United States and abroad. Last year, EOG's production on an energy equivalent basis was 93% natural gas and 7% crude oil, reflecting Enron's overall focus on natural gas. During the first half of 1997, EOG produced for its own account approximately 5000 barrels per day of crude oil and condensate and 275 Million cubic feet per day of gas from federal lands, making it a significant independent producer of oil and gas on the public domain. A wholly owned subsidiary of EOG, Enron Oil Canada, Ltd., is active in the exploration and production business in Canada and has participated in one of that country's province's royalty-in-kind program on the oil side.

Through its gas pipeline group, Enron is a leader in natural gas transmission. It is comprised of four interstate natural gas pipelines, Northern Natural Gas, Transwestern Pipeline, Florida Gas Transmission and Northern Border Pipeline. In addition, this group also operates two intrastate pipelines in Texas and Louisiana. The combination of these systems equals more than 32,000 miles of mainline transmission pipeline.

Also affiliated with Enron Corp. is EOTT Energy Partners, L.P. (EOTT). EOTT, through its operating limited partnerships, is engaged in the refined products, natural gas liquids, and crude oil marketing and transportation businesses, both in the United States and in Canada. Like ECT, EOTT purchases oil produced from the public domain. Enron Corp., Northern Border, EOG, and EOTT are each public companies whose shares, or in the cases of EOTT and Northern Border, limited partnership units, are traded on the New York Stock Exchange.

Because of natural gas's importance as an environmentally sound fuel and because significant quantities of this country's natural gas reserves are located on federal lands both onshore and offshore, Enron believes that the method used in determining federal royalties is critical to the efficient development of our energy resources. One fifth of our nation's oil reserves and one third of our gas reserves are located on federal lands. Natural gas is an abundant, versatile, and reliable fuel with domestic production accounting for over 85% of national consumption. Natural gas is the fastest growing input of the electricity generation sector. Perhaps best of all, when burned in state-of-the-art combined-cycle units to generate electricity, natural gas reduces pollution emissions between 50% and 100% in the eight major categories compared to advanced coal-fired technologies.[1] As the Department of Energy summarized last year in its International Energy Outlook[2], "*natural gas is the cleanest of the fossil fuels, and reserves are abundant. Environmental considerations and technological advances in gas-fired electricity generation are making it the fastest-growing fossil fuel worldwide.*" For these reasons, federal royalty policies should be considered in a broad, dynamic context.

Gas Industry Background

Recent changes in the natural gas industry, including the deregulation of wellhead prices and the demise of pipelines as the primary purchasers of natural gas, directly affect the current debate over royalty valuation. For decades the interstate natural gas industry was tightly regulated. Wellhead prices for natural gas were subject to federally mandated price ceilings. Most gas was sold to interstate pipeline companies that transported the gas to end users such as local distribution companies. Today, federally initiated market reforms have resulted in a robust wellhead market. Regulated wellhead prices for gas dedicated in interstate commerce were entirely repealed in 1993. Pipelines are primarily transporters, not purchasers of natural gas. Merchant sales by interstate transmission companies were replaced by marketing companies and open-access transmission between 1985 and 1993. And around the country, states are beginning to implement open-access distribution programs to allow end users to procure natural gas from their preferred supplier and turn to their local distribution company for transportation services only.

These changes in the natural gas market have resulted in seemingly intractable disputes between royalty recipients and producers of gas, both in the public and private sectors. I will briefly discuss some of the issues that have arisen between federal lessees and the federal government momentarily. It is our belief, however, that most, if not all, of these problems can be substantially eliminated by introducing a program in which the federal government takes and markets for its own account its share of oil and gas production from the public lands. At the same time, we believe that a properly designed program can provide the government with the assurance that it is receiving the full market value for its share of production while simplifying and streamlining its operations. In short, we believe that a properly designed royalty-in-kind program can result in a "win-win" situation for both the government and the private sector.

---

[1] Gas-fired combined cycle plants offer the following emission reductions: sulfur dioxide, ash, and sludge (-100%), particulates (-95%), nitrogen oxides (-81%), and carbon dioxide (-58%). Study by ICF-Kaiser for Enron Corp., June 1996.

[2] Energy Information Administration, International Energy Outlook, May 1996, p. 35.

The Elements of a Successful Royalty-in-Kind Program

We believe that the essential principles necessary for the implementation of a successful royalty-in-kind program are *simplicity*, *predictability*, and *fairness*. Under the current system, royalties are based on the value of production. Value is to be determined on the basis of the producer's receipts when he or she sells the production under an arm's-length contract. The federal share of production is sold along with that of the producer. Since the royalty share is typically only one-eighth (for onshore production) or one-sixth (for offshore), the government's interest is protected since it is in the economic self interest of the producer to obtain the best price possible for the lion's share of the production.

When a producer is affiliated with a company that is active in the midstream or downstream markets, matters become more complex. Value is still to be based on the prices established under the arm's length contracts, but the producer's receipts are no longer used to determine the royalty obligation. They are to be compared with the prices received by other producers in the field or area where production occurs to make sure that the non-arm's length proceeds are comparable. The problem from a producer's standpoint is that, for competitive and anti-trust reasons, he or she cannot simply call other producers in the area and make inquiries concerning their prices. Further, the value for royalty purposes can never be less than the producer's proceeds, but it can be more. The proceeds which would have been deemed the value if sold to a non-affiliate are left open to question. Such a producer is left in uncertainty as to whether or not the value used for reporting and paying the government for its share of production was correct. And value, like beauty, is in the eye of the beholder, especially years down the line when the producer's payments are subject to audit.

Benefits of a Royalty-in-Kind Program

The above is a vast oversimplification of the current system, but in its essentials, it is correct. There have been in recent years many efforts to deal with these issues. A Negotiated Rulemaking was instigated by the Secretary of the Interior in an effort to come up with new rules to value gas. That committee's work resulted in the publication of a complex proposed rule that, due to a number of factors, was ultimately withdrawn. Other proposals and issues currently confront the government and the industry. A well designed royalty-in-kind program would cut through these problems. Simplicity would be achieved for both the government and the producer. The government could, like the Province of Alberta, utilize the expertise of private sector experts in marketing its production for a fee rather than attempting to develop its own internal expertise in this complex area. Producers would enjoy both a vastly simplified system of complying with their obligations to the government and the knowledge that they will not be second guessed years later concerning the values upon which they reported production. Fairness would also be achieved on many fronts. Small producers and large producers would be treated similarly. Companies that are active in multiple phases of the industry would not be placed at a competitive disadvantage as a result of engaging in more than one line of lawful business.

A. Advantages to the Government

A well designed royalty-in-kind program offers many advantages to the federal government over the current program of receiving royalties based on value. Such a program would assure the government that it receives the full market value for its share of production. The most sophisticated marketing companies offer the ability to access markets nationally, and to provide both efficiencies in operation and economies of scale. Such companies also offer access to sophisticated information systems that will allow the government to receive timely and accurate information.

By utilizing the expertise of sophisticated marketers, the federal government should realize increased revenues through the aggregation of its substantial volumes, as well as significant administrative savings resulting from greatly simplified auditing requirements, an absence of disputes with producers concerning the value of production, and a reduction in administrative appeals and litigation resulting in a streamlined, more efficient agency.

B. Advantages to Producers

As an aside, I'd like to note that Enron Oil & Gas Company is member of both the Domestic Petroleum Council and the Independent Petroleum Association of America. As members of these organizations, we have participated in the formulation of their recommendations and fully endorse their comments to this subcommittee.

I would now like to describe the benefits that we have experienced with a royalty-in-kind program in Canada. As I previously noted, EOG, through its wholly owned subsidiary Enron Oil Canada, Ltd., produces oil in the Province of Alberta, Canada that is subject to Alberta's royalty-in-kind program. Our experience under that program has been extremely positive. Valuation disputes under the program are virtually nonexistent. Further, the program is simple to administer from both a logistical and an accounting standpoint. Its chief attraction is its practicality. We are able to comply with our royalty obligations by implementing relatively simple computer programs and relying upon a single accountant who spends less than four hours a month in filing required reports. In addition, the Province bears its proportionate share of downstream costs like any other interest owner, thus providing equitable treatment to its lessees.

We also note that since June, 1996 Alberta has utilized the expertise of three marketing companies in disposing of its share of oil production. Prior to that time, Alberta's oil production was marketed by the Alberta Petroleum Marketing Commission, a government agency formed in 1974 to gather and market the province's crude oil and synthetic crude received in-kind as royalty from Crown leases.

In February 1994, the Alberta government announced that it was getting out of the oil marketing business as a part of a major restructuring and downsizing of the Ministry of Energy. Most significantly, between February, 1994 and April, 1995 a joint government-industry task force exhaustively examined the feasibility of moving to a value-based cash royalty system such as is presently used in the U.S. In April, 1995, the Minister of Energy advised that a cash based royalty system could not be implemented because it would result in a *financial loss* to the province ***and create an administrative burden*** for both industry and government.

We believe that our experience in Alberta shows exactly the benefits to both the industry and to the government that a well designed royalty-in-kind system can have. We accordingly urge that this subcommittee give serious consideration to the experience of our Northern neighbor in judging the efficacy of royalty-in-kind programs.

I would also like to briefly discuss our experience under the Interior Department's pilot royalty-in-kind program conducted in the Gulf of Mexico during 1995. While we did note some logistical and reporting problems, our overall view of the program was positive. I think that those who participated in the program, both in the private sector and in the government, recognize that there were minor problems with the pilot program. These problems do not, however, cause us to question the overall desirability of a successful royalty-in-kind program. Rather, they serve to prove the old saying "the devil is in the details." These details can best be addressed by utilizing the experience of those who participate in the industry, both producers and marketers. Only in this way can a system that meets the needs of the federal government and the industry be met. We would be pleased to assist in the development of such a system in any manner possible.

In addition, we recently began to participate in the royalty-in-kind program covering lands owned by the State of Texas. A property we acquired last year from Amoco was already in the program when we acquired it. The State of Texas, through its General Land Office, takes its share of gas at the wellhead. It has its own transportation arrangement. Basically, the State is treated like any other owner in the property. The program works so well that no one at Enron, other than the personnel who actually administer the property, was even aware that we were a part of the program until we looked into it as a result of an inquiry by this committee's staff. The fact that the program operates so unobtrusively speaks volumes.

Current Concerns

As I previously noted, the recent changes in the natural gas markets have led to a number of controversies between industry and the government. Other controversies have arisen concerning whether or not posted prices for oil are indicative of true market values. Central to the government's position in connection with these controversies is its abandonment of the view that royalties are to be determined at or near the lease as has been the historical practice for more than seventy years and thus a matter upon which federal lessees have relied. Rather, it is apparently the current view of the Department of the Interior that royalty values are to be determined far downstream of the lease, after the value of the commodity (whether oil or gas) has been enhanced by a variety of services performed in the midstream and downstream markets and with respect to which participants in those markets have made significant capital expenditures and undertaken a variety of risks not associated with the risks that are undertaken by oil and gas lessees. As a salient example I point to the Minerals Management Service's recently proposed rule that would establish crude oil values not on the basis of prices received under arm's-length contracts for similar production in the field where produced, but rather on values determined under financial contracts traded on the New York Mercantile Exchange, adjusted for differentials in value, quality and distance from Cushing, Oklahoma. NYMEX contracts are essentially financial hedging instruments and seldom are contracts for the physical delivery of oil. However, the problems encountered in making the many necessary adjustments to a NYMEX price to even roughly approximate the values established in the myriad individual wellhead markets throughout the United States are insurmountable and the resulting burden on lessees unconscionable.

In a recent Federal Register notice, MMS indicated that it intends to radically alter its present definition of an arm's length sale, the linchpin of the current MMS valuation rules. This latter proposal is of the utmost concern. MMS would redefine arm's length sales to mean the first sale outside a group of affiliated companies. Such a rule would require a wholesale revision in the manner in which much of the natural gas business in the United States is today conducted. Gas has become, like grain, porkbellies or orange juice, a fungible commodity. Gas is purchased, aggregated and disposed of through ever more complex transactions. The risks undertaken by those companies, including Enron, which have participated in this revolution in the midstream and downstream gas markets are far removed from the risks historically required of oil and gas producers.

Companies such as Enron (and there are many) which participate in both the production phase as well as the midstream and downstream markets would be placed at a severe competitive disadvantage if such a rule were ever to become law. Competing producers could rely on the price they received in determining their royalty obligation while producers with downstream affiliates would be subject to significantly increased record keeping and compliance costs as well as being subjected to second guessing concerning its reported values years later. Such a rule would unfairly penalize companies that engage in more than one level of production and distribution.

Further, any such rule is fundamentally at odds with the manner in which natural gas is marketed today. Natural gas producers no longer dedicate the production from specific properties to specific sales contracts. Most production today is sold under contracts that specify no source of supply, but rather require that specified volumes are to be delivered to designated delivery points. Producers can and do supply gas to such delivery points from various sources of supply, including their own production or, in the event of a shortfall in production necessary to satisfy a firm delivery commitment, by purchases from other producers or marketers. Even when a producer's own production is used, it may come from any number of properties upstream of the point of delivery thus rendering impossible the determination of downstream resale proceeds from any specific property.

Similarly, midstream marketers do not supply their downstream customers with gas obtained under specific purchases from identifiable producers. Rather, production is aggregated at pooling points where it is bought and sold or transported to other points, all in the marketer's efforts to maximize its profits by seeking the best market that is available. In short, such a rule would be tantamount to requiring a bank to calculate the interest it earns for loaning the money of a specific depositor. The total impracticability of any such a rule if applied to the banking industry is obvious. It is no less so in the natural gas business.

These proposals, and there are others as well, reflect a view by the MMS that it should substitute its own regulatory oversight for market forces. It has been said that those who know no history are doomed to repeat it. I simply call to your attention the morass of litigation, regulatory uncertainty, and market distortions that have accompanied every attempt to substitute governmental judgment for competitive market forces in the oil and gas markets. The regulatory quagmire resulting from governmentally mandated pricing distinctions between "old oil" and "new oil" in the 1970's and the tremendous burdens on both government and the industry resulting from federal attempts to regulate wellhead prices for natural gas from the mid-1950's through 1993 come immediately to mind.

Conclusion

It is for these reasons that a royalty-in-kind program is so important. Competitive bidding for the government's share of production would simply and fairly establish its value while providing the best means available to assure that the government receives full value for oil and gas production from federal lands. It offers the government the ability to realize the maximum value for its share of production while streamlining its operations. In short, we believe that such a program will provide certainty, simplicity, and fairness for the government and the industry. Our experiences in Alberta and Texas confirm this belief. Accordingly, we urge that this subcommittee give serious and favorable consideration to the establishment of a royalty-in-kind program for the federal share of oil and gas production.

I would like to thank the members of the subcommittee for this opportunity to testify before you today and offer our assistance in developing a successful royalty-in-kind program that will meet the needs of both the federal government and the oil and gas industry.

I would welcome any questions you may have.

Edmund P. Segner, III
Executive Vice President & Chief of Staff
Enron Corp.
1400 Smith Street
Room EB-5025
Houston, TX 77002
(713) 853-5299

EDMUND P. SEGNER, III
Executive Vice President & Chief of Staff
Enron Corp.

Edmund P. Segner, III is executive vice president and chief of staff of Enron Corp. Prior to assuming his current position, he was senior vice president of investor, public and government relations at Enron. He joined the company in February, 1988 as vice president of public and investor relations. He serves as a director of Enron Oil & Gas Company and Enron Global Power & Pipelines, L.L.C., listed on the New York Stock Exchange as EOG and EPP, respectively.

Before joining Enron, Ed was assistant vice president for equity research at Drexel Burnham Lambert, Inc. Previously, he worked for eight years at United Energy Resources, Inc., and began his career in 1976 as a member of the audit staff of Touche Ross & Company.

Ed graduated cum laude from Rice University with a B.S. degree in civil engineering and received a M.A. degree in economics from the University of Houston. He is also a Certified Public Accountant.

Ed is a member of the Houston Society of Financial Analysts. He is Treasurer of the Texas Nature Conservancy and on the advisory board of the Zoological Society of Houston. Ed is a member of the Rice University faculty. He also serves on the Rice University Fund Council and the advisory board of the Rice University Center for Education. Ed is past Chairman of the Board of Community Partners.

January, 1997

TESTIMONY OF

Cynthia L. Quarterman, Director

Minerals Management Service
U.S. Department of the Interior

Before the

Subcommittee on Energy and Mineral Resources
Resources Committee

House of Representatives

July 31, 1997

Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Minerals Management Service's (MMS) ongoing examination of the feasibility of taking oil and gas royalties "in kind." We are undertaking this study as part of our continuing efforts to improve services to the public at reduced cost. We are also responding to a congressional directive to consider additional royalty in kind scenarios. Before discussing details of our current study, I would like to provide you with some background information.

Background

The Department of the Interior has historically based oil and gas royalty valuation on fair market value, typically defined as the gross proceeds realized by its lessees under arm's-length sales. For many years, this served as an equitable valuation standard and continues to work well today in cases of wellhead or producing area arm's-length sales. However, the energy industry has changed dramatically over the past 10 years.

With respect to crude oil, the world events of the 1970's produced new price volatilities and an active spot market. Spot trading at producing area market centers by middlemen, such as brokers and re-sellers, has increased compared to the traditional long-term contracts between producers and refiners. Further, many sellers now use the futures market for risk management and market information. Product exchanges are now a common method of disposing of production.

With respect to natural gas, the Federal Energy Regulatory Commission's (FERC) deregulation of the natural gas transportation industry, the widespread emergence of producer affiliates and joint venture marketers, and the evolving deregulation of retail natural gas and electric markets have complicated royalty valuation.

The once-dominant wellhead sale has been replaced by more frequent "downstream" sales by affiliated energy marketers, especially for natural gas. A series of downstream transportation, processing, marketing, and risk management activities (e.g. price hedging) — even inter-commodity exchanges (e.g., from gas to electricity) — frequently occur before a first sale is made, thereby complicating the tracing and calculation of a lessee's gross proceeds. In some instances, for example, a gas producer's first sale may not occur until the burner tip in a residential consumer's home.

The changing nature of the current energy market has, unfortunately, fostered disputes between MMS and producers over the appropriate royalty valuation for oil and gas. For example, we have had disputes over how much of the downstream revenues should be included in gross proceeds, what deductions are appropriately made from gross proceeds for downstream services, and to what extent is the lessee's duty to market for the lessor at locations remote from the lease. Administrative appeals and litigation have proliferated as MMS and the energy industry have struggled to resolve these issues.

Changes in the energy market have presented great challenges for MMS to provide simpler and more certain royalty valuation regulations and guidance. MMS has attempted to meet the challenge through a series of regulatory and policy actions, using negotiated and revised valuation rulemakings. Regulatory and policy solutions developed to date have often been controversial. However, we believe that progress towards solutions to royalty valuation disputes is tangible and that we are on the right path to successfully addressing these issues.

Part of this "right path" may include implementation of a royalty in kind (RIK) program or programs. The complexity and divisiveness surrounding existing royalty valuation have prompted us and many in the oil and gas industry and Congress to consider the potential benefits of RIK programs. In the best case RIK scenario, valuation disputes could be eliminated or at least reduced. Auditing lessees' production could consist of straightforward volume reconciliations completed soon after the production month. Administrative savings could accrue to both the Federal government and industry through decreased royalty reporting and verification. The potential may exist to enhance Federal revenues through significant aggregation and sophisticated marketing. The extent of such benefits, however require more examination and analysis. While the RIK program offers possibilities for the marketing of Federal production, it also places the government into a new role similar to that of a working interest owner sharing in benefits and risks.

MMS recognizes the potential for these benefits and, accordingly, we are seriously examining the feasibility of adopting RIK programs. Before discussing the early results of our examination, I would like to speak briefly of MMS' 1995 Royalty Gas Marketing Pilot during which MMS took a percentage of its offshore gas production in kind.

1995 Royalty Gas Marketing Pilot

During calender year 1995, MMS took and sold by competitive bid at the lease approximately 45.6 billion cubic feet of gas from 14 lessees covering 79 leases in the Gulf of Mexico, accounting for approximately 6 percent of the U.S. royalty share of Gulf of Mexico natural gas production. The pilot was an operational success, proving that RIK sales are feasible, however, royalties were some 9 cents per MMBtu less than would have been realized under the in value system. Extrapolated to all Gulf of Mexico Federal leases, this loss would have been approximately $82 million annually. MMS learned a substantial amount about RIK concepts from the pilot and from subsequent interaction with gas producers and marketers, including:

1) The voluntary nature of the program put MMS at a disadvantage that likely contributed to revenue losses, the most obvious disadvantage being that volunteered leases were scattered throughout the Gulf, reducing opportunities to aggregate volumes and enhance values.

2) Sales at the lease resulted in MMS not realizing value enhancements from downstream marketing services, natural gas liquids uplifts, and aggregation.

3) Administrative relief to MMS and industry did not occur because only a few leases were included and audits of the producers' shares were still conducted.

1997 RIK Feasibility Study

The primary objective of our current study is to determine if implementation of an RIK program or programs for Federal oil and gas is in the best interests of the United States, and, if so, under what circumstances. We use the phrase "best interests of the United States" to refer to a program that would:

1) Offer potential revenue neutrality or enhancements to the U.S. Treasury; and

2) Provide extensive administrative relief for MMS and industry.

The study considers both small-scale pilots and across-the-board, "steady-state" programs involving substantial volumes of Federal production. In the study, we are assuming that the following conditions would have to prevail for the U.S. to successfully implement an RIK program or programs, namely:

1) Federal lease rights to take in kind would be exercised at our option.

2) Regulations would be promulgated.

3) Market value benchmarks would measure program success.

4) MMS would not audit the lessee's production share to measure value.

During the study, we have conducted several types of research, including: 1) interviewing governmental entities to learn from their RIK experiences; 2) convening public workshops to obtain public input on a spectrum of potential RIK options under consideration; and 3) surveying energy marketers to learn more about how energy commodities are marketed and sold downstream of the lease.

Other RIK Experiences. The Texas General Land Office (GLO) takes oil and gas in kind from State leases. The GLO's oil is sold by competitive bid at the royalty measurement point. GLO staff stated that RIK revenues are some 5% more than in value revenues. The GLO is currently in dispute, just as the MMS is, with many producers over the value the GLO receives in royalties. Generally, the in value royalty payments were based on postings. GLO has recently reached settlement with at least one integrated producer to pay royalties on a NYMEX adjusted price, rather than postings. Our understanding is that the advantage of the oil RIK competitive bid price compared to the negotiated royalty valuation has disappeared.

The GLO's gas RIK program provides gas to State facilities as an alternative to services provided by local utilities. Excess gas is sold on the spot market. The program has two primary goals: 1) to enhance the School Fund, and 2) to streamline the GLO royalty program. The GLO sells approximately 1 Bcf per month from 100 state leases in the Gulf. The GLO reported that the program has resulted in about $1 million, annually, in additional revenues and about $10 million, annually, in savings from decreased gas prices for State facilities by cutting out the local utilities. Our understanding from GLO, is that the local distribution companies are now becoming more competitive to try to gain the State facilities back as customers. The schools are receiving more competitive prices, however, the State is reducing its margin to remain a competitive supplier. Later, I will discuss our findings on gas from the OCS.

During the past 3 months, we have spent some time learning about the experiences of other governments in RIK, especially the Province of Alberta's RIK oil program. Under this program, the entire Province's Crown (royalty) share is delivered at the oil tank battery. The Province's marketing agents combine Crown production with their own equity production, and move the crude oil significant distances to refineries where sales occur. The agents are paid a per barrel marketing fee. The Alberta crude oil RIK program is reported to be slightly revenue positive compared to refinery postings. We understand that the Alberta benchmark prices are comparable to U.S. market center prices, for example, the Empire and St. James market centers. Alberta has told MMS that their small revenue enhancement primarily results from movement of the Crown's production away from remote areas with little refining capacity and demand to areas of many refineries with greater demand for crude volumes.

The Alberta RIK program provides an interesting model for us to consider as we move forward in assessing RIK programs. I will speak further to this model later today.

The State of Wyoming has formally expressed interest about creating a pilot RIK program. We have met with them several times to explore that possibility. We remain open to work with the State and industry in formulating a pilot program in Wyoming. Our offer to the State that we develop a joint implementation team remains open.

Public Comment. MMS conducted six public workshops to obtain public comment on RIK feasibility. The primary public reaction to MMS' RIK options was widespread support for MMS to take oil or gas production in kind. This sentiment was expressed by large and small producers, marketers, field service companies, pipeline companies, and State governments. Comments from marketers and some producers indicated that gas RIK has more potential for revenue enhancement than does oil RIK. Their rationale is that the Federal government's royalty strength is in its ability to aggregate large volumes of production. That characteristic is not as important in the oil market because it consists of refiners that typically look for incremental barrels to fill excess capacity rather than for large volumes to fuel ongoing industries as is the case in the gas market. Further, some commenters indicated that a large-scale RIK program would work better for offshore leases in the Gulf of Mexico because of the concentration of volumes in a relatively small area with mature pipeline/market infrastructures.

Public comment supported delivery of U.S. royalty production at the lease, followed by either lease sales or downstream sales by a contracted marketing agent as the best options. Both producers and marketers urged MMS to adopt bold programs (rather than "pilot projects") involving substantial volumes and long time periods. Producers cited significant administrative savings and marketers asserted revenue enhancements as the basis for their opinions.

Market Survey. MMS conducted a survey of natural gas marketing companies to understand this aspect of the business and to determine the implications and potentials for marketing of U.S. royalty gas production. The energy marketers appear to possess three attributes that they could provide to MMS that have positive implications for marketing of U.S. royalty gas:

1) Knowledge and experience gained in swapping/trading multiple commodities;

2) Efficiencies from moving large volumes; and

3) The full spectrum of marketing services (e.g. storage, transportation service portfolios, commodity swapping/arbitrage, risk management, trading on location differentials, and knowledge of and relationships with pipelines, gathering systems, processors, and customers).

Each of these attributes could potentially increase the revenues the government would receive from gas production. The gas marketers each contend that MMS can enhance offshore gas revenues by strategic alliances with energy marketers. The primary reason offered by marketers is that MMS could provide market leverage for an agent by virtue of the large magnitude of supply from a single source. The same reasoning apparently underlies the recent private joint ventures between major producers and gas marketers.

Preliminary Findings. Our examination and deliberations on potential future RIK programs are still ongoing, and, as such, the findings I discuss here today are still quite preliminary. However, we offer some of our tentative findings to generate discussion and to let you know the status of our analysis at this point in time. An overall finding of the study will likely be that, under favorable circumstances, RIK programs could be workable, revenue neutral or positive, and administratively more efficient for MMS and industry. Favorable circumstances include:

1) **Downstream Marketing and Sales**: An MMS RIK program that can strategically participate in downstream services and value enhancements could improve Federal royalty revenue.

2) **Aggregation**: The ability to aggregate and supply substantial volumes to end-user markets could provide MMS and its agent with market leverage primarily through assurance of supply.

3) **Administrative Relief**: Decreased reporting to MMS, and the reduction of audits of the producers' shares would benefit both the U.S. and the royalty payors.

However, RIK programs would have reduced chances for success if implemented under unfavorable conditions, including:

1) Continuation of audits of the producers' shares;

2) Statutory language reversing our current RIK authorities by:

   a) requiring MMS to take royalty in kind only at the lessees' discretion;

   b) limiting our ability to have RIK volumes transported by the lessee at cost or requiring us to pay above market transportation rates on non-jurisdictional gathering lines to move royalty production; or

   c) requiring MMS to accept RIK volumes at less than marketable condition.

3) Taking in kind Federal production scattered throughout many basins in a relatively large geographic area, which would decrease the potential for aggregation of volumes and increase the MMS learning curve for implementing RIK programs.

With respect to crude oil, we caution against assuming that the Alberta program is directly relevant to U.S. crude oil RIK potential. First, the Alberta revenue information covers only one 6-month period and is only marginally positive. Second, the stated reason for the small revenue enhancement in Alberta—movement of crude oil substantial distances to areas of greater refining demand—would likely not occur in the Gulf of Mexico. This is because the U.S. Government should already be receiving royalties under the current in value scheme based on relatively high demand in the Gulf which results from a high concentration of refineries. Further movement downstream under an RIK system would likely not result in higher prices.

For onshore, implementation of a new crude oil RIK system would be large and complex because of the scattered nature of the production. This would make such an RIK program a difficult undertaking that should be attempted only if revenue and administrative impacts for all parties are decidedly positive.

MMS believes that our proposed crude oil valuation rule promises to provide for certainty in oil valuation partly by utilizing transparent market indicators tied to producing area market centers. Under an oil RIK program, it is likely that the Government would realize proceeds similar to those quoted at the market centers, which is the basis for our proposed valuation rule. Considering that lessees cannot deduct marketing costs under the Federal in value system, we believe that implementation of an oil RIK program would actually lose revenue because MMS would need to pay these costs under an RIK program without the potential for volume aggregation or downstream value enhancements of a gas RIK.

In summary, we are not convinced that crude oil RIK is in the best interests of the United States. However, we have not yet quantified the relationship between direct revenue implications and potential administrative savings for oil RIK. We are, therefore, willing to work together with industry, States and the Congress to develop and conduct a pilot program that might help provide these answers.

With respect to natural gas, we believe that a gas RIK that uses one or more marketers has the potential to enhance revenues because:

1) MMS could receive more benefits from downstream sales of gas and associated liquids than currently received at the lease;

2) the potential to aggregate production would increase under RIK if existing lessees of offshore royalty gas are replaced by one or a few marketers;

3) downstream value additions may be more quickly captured by RIK programs than under in value royalties that are currently in litigation; and

4) gas marketers generally have a more diverse portfolio of transportation options than many producers, and can thus use the most appropriate service to exploit lucrative yet often short-lived marketing opportunities.

In sum, we are encouraged by the prospects for gas RIK from both revenue and administrative perspectives. We intend to proceed cautiously to develop specific program models consistent with the favorable conditions I previously mentioned, and to assess their feasibility before we make any firm decisions on whether or how to implement a new RIK pilot.

Next Steps

I reiterate that the findings I have outlined here today are preliminary, and that, upon further detailed economic and program analysis, different conclusions may be reached. We will not make any decisions before such analysis is completed. We further believe that it is not wise to make legislative decisions before comprehensive analyses are conducted. Any statutory or regulatory assistance that may be necessary will depend on the specific nature of any RIK program that is developed. At this point, it is premature to guess what type of legislative assistance, if any, may be needed.

Specifically, our course of action will be the following. We will first complete our conceptual assessment of potential future RIK programs. We then intend to work together with Congress, interested States and the industry to identify specific areas of interest in RIK. If indications remain positive that certain RIK scenarios should be pursued, we will develop detailed program specifications that can then be assessed for their likely fiscal and administrative impacts. Decisions will follow.

In closing, let me state that the Department of the Interior is quite open to alternative and innovative ways to manage the revenues generated from the Nation's public resources. We understand that the energy markets have changed dramatically from those in existence when our valuation regulations were published in 1988, and that these still evolving changes require us to be agile and flexible in our approach so that both government and industry have workable systems to manage royalty revenues. It is precisely that need for agility and flexibility that leads us to believe that a legislatively constructed program might lock in elements of an RIK program that would later turn out to be counter to the operations of the marketplace. We continue to work on two fronts to meet this challenge, namely to develop clear and certain valuation regulations for in value royalties, and to explore and implement RIK programs where they are workable and beneficial to all parties.

Madam Chair, this concludes my prepared remarks. I would be pleased to answer any questions you or the Members of the Subcommittee may have.

GULF CANADA

AND

ALBERTA'S CRUDE OIL ROYALTY SYSTEM

REMARKS TO THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE OF RESOURCES

SUBCOMMITTEE ON ENERGY AND MINERAL
RESOURCES

OVERSIGHT HEARING ON ROYALTY-IN-KIND

William G. Henderson
Gulf Canada Resources Limited

September 18, 1997

1082-1 (6-84)

GULF CANADA AND
ALBERTA'S CRUDE OIL ROYALTY SYSTEM

OUTLINE

Profile, History & Process Description

Alberta Production and Royalty Profile.................................. 3

Crude Logistics and Pricing..3

Recent History of Royalty Collection.......................................4

Government Royalty Review – 1995/96...................................4

Description of Current Royalty-in-Kind Process.......................6

Gulf Canada's Experience To-date

Background of Gulf..7

Agency Agreement Perspectives...8

BACKGROUND, HISTORY & PROCESS DESCRIPTION

Alberta Production and Royalty Profile

Crude oil production in Alberta currently totals 1.2 million barrels per day of which approximately 81% or about 970,000 bpd is produced from Provincial government or "Crown" leases. The latter represents land where the Province has retained the mineral rights. The remainder is produced from freehold lands, which primarily consist of railway right-of-ways, Aboriginal reserves and original settlers' leases.

Conventional production from Crown leases is about 740,000 bpd. It is upon this volume that royalties in kind are based. For the government year-ended March 1996, net Crown royalties totalled 130,000 bpd and averaged 18.1% of conventional Crown lease production. Provincial royalty percentages vary with differing crude oil qualities and are market price sensitive. As a result, royalty volumes can vary significantly from month to month.

Not all royalties are delivered in kind as certain production from enhanced oil recovery schemes and oil sands is collected in cash. Provincial royalties are not charged on freehold production as instead the freehold owners are charged a mineral tax. This is collected in cash once per year.

Crown royalties are produced from about 6,000 oil batteries connecting to an estimated 25,000 to 30,000 wells. There are some 500 companies operating in the Province; however the majority of these are small producers with volumes under 1,000 barrels per day. Over one-half of total production rests with thirteen companies of which seven are integrated with refinery operations.

Crude Logistics and Pricing

Alberta has two primary delivery hubs – Edmonton and Hardisty. Light feeder streams deliver into Edmonton for shipment on Interprovincial Pipe Line (IPL), Transmountain Pipeline and Express. Medium and heavy streams deliver to Hardisty for further shipment on IPL and Express. Most Canadian crudes are shipped on IPL for sale in the Chicago and Ontario markets. However, substantial volumes are also sold into the Edmonton area, Pacific Northwest, U.S. Rocky Mountain Region and southern PADD II.

For volumes sold in Canada, pricing is usually based on two markers:

- Posted prices issued by Canadian refiners and a few trading companies reflecting the price for which they will buy crude at either Edmonton or Hardisty. These prices reflect a variety of different crude qualities.

- A differential off Nymex WTI dependent on quality, location, and market conditions.

For volumes sold in the U.S., prices are based on conventional pricing methods including postings, Nymex, Platt's, etc.

Recent History of Royalty Collection

Previous to 1974, the Alberta Government collected royalties owing on a cash basis with prices determined from actual company proceeds. Following the oil embargo and energy price shocks of the early 1970's, the Canadian federal government threatened to impose severe oil price controls on the entire Canadian oil industry. This move was completely opposed by the country's net producers including the Alberta government. So as to give the Province leverage in negotiations with the federal government, the Province created the Alberta Petroleum Marketing Commission (APMC) in 1974. At that time the legislation required all crude oil produced from Crown leases to be delivered to the APMC.

In 1985, oil prices were completely deregulated and the APMC ceased to be the exclusive marketer for all Crown lease volumes. Instead, only Crown royalty volumes and the Province's equity share of volumes produced from the Syncrude oil sands plant were placed under the marketing control of the APMC.

Government Royalty Review – 1994/95

In 1994, the government in power was mandated to review the role of all government departments, boards, and agencies with a view to reduce the influence of government as well as cut costs. The APMC was included in this review and it was recommended that the APMC's functions be assumed by private industry. An industry/government task force was struck to develop the most desirable and cost effective way to implement this recommendation. Evaluation criteria were developed among which included revenue neutrality as compared to the previous system, minimal administrative burden upon producers, fairness and transparency and lower or the same government administrative costs.

Three potential options were developed and reviewed:

1. a self-determined price cash royalty system

    - royalty valuation would be based on actual prices received upon the sale of all producer's production with working interest owners in the well or battery being responsible for payment.

- this option was favored by the majority of industry's largest producers including integrateds as it allowed them to keep control of their royalty volumes
- it was rejected by the government due to the extensive audit component that would be required, the problem in valuation of non-arm's length sales and the intrusive administration and reporting required

2. a reference price cash royalty system

   - royalty valuation would be based on marker prices netted back to the field location
   - although the second choice of the larger industry producers, the option was rejected by the government as it was determined not to be revenue neutral

3. privatization of sales using existing multiple marketers or an existing single marketer

   - this option was originally rejected by the task force due to the general opposition by industry and the problem in developing appropriate bid criteria and performance benchmarks. Opposition was generally in the context of large volume control.
   - later, and as a result of proposals submitted by a number of producers, the government revisited this option with a view to privatizing on an agency basis

In late 1995, the government formally requested proposals from industry incorporating various criteria including:

- acting as agent for the government using a pooling approach whereby the Crown's volumes would be pooled with the agent's volumes and both parties receiving the same price.
- a term of 5 years or less
- appropriate credit worthiness and marketing history of the agent
- fee to be charged
- performance criteria
- risk management activities
- intelligence gathering for the government

After an extensive negotiation process, Gulf Canada was chosen as one of three agents to market the royalty volumes. As Gulf's production consisted predominantly of light, sweet crude oil, the volumes awarded also consisted of light sweet oil.

In addition to marketing the Crown's share of royalty production, Gulf was also requested to manage three policy initiatives that were currently being handled by the APMC:

- The Westcoast initiative-a process to help manage chronic apportionment levels on IPL whereby production in excess of available pipeline capacity was moved to lower value markets in the Pacific Northwest and offshore. The price differential between Edmonton values and the actual sales values was charged to the royalty program with all Crown producers sharing in the cost. Volumes transported and sold under this program ranged between 10,000 to 120,000 bpd. This initiative ended in March 1997.

- Purging of Line 9 volumes-in 1993, the APMC reactivated the Sarnia to Montreal portion of IPL in effort to provide an outlet for excess Canadian production and as a defensive posture against early reversal. Again the costs of this program were shared by industry through adjustments to the royalty formulas. In 1996, the linefill volumes were recovered and the line purged.

- Managing the government's Express Pipeline take-or-pay commitment - in order to ensure the Express Pipeline system would be built, the Alberta government committed to a substantial and long term take-or-pay throughput volume. This commitment is ongoing with certain portions of the commitment lasting 15 years. Crown sales through this commitment are pooled with Gulf volume sales on its commitment.

Description of Current Royalty-in-Kind Process

The current in-kind process has many components but can be summarized as follows:

- Lessee obligation - Under the current Provincial legislation, the ultimate obligation for royalty rests with the lessee with volumes to be delivered in-kind to the Crown's agent at the closest field delivery point which may include a pipeline, terminal, refinery or other pipeline connected facility.
- Ownership - Because of the agency relationship, ownership of the oil rests with the Crown from production to ultimate point of sale by the agent.
- Operator based - As the operator of the producing facility is responsible for delivering the partner's share of production to the nearest delivery point, it is also responsible for ensuring delivery of the royalty share to the Crown's agent. The operator is also responsible for forecasting of the following month volumes to the appropriate parties including pipeline/terminal operators, buyers (Crown's agent in the case of royalty) and owners. This process

occurs during the first two weeks of the month prior to the month of production/sale.

- Field Inventories – Royalty volumes are deemed to be delivered first and as a result no royalty inventories are held at producing battery locations.
- Delivery and sale – once the royalty volumes are delivered to the agent, the volumes are pooled with the agent's volumes for sale and delivery to market. In Gulf's case, three pools are used for revenue distribution: light sweet at Edmonton, light sour at Edmonton and light sour in northeast British Columbia. Note that these pools are location and quality based. Other sour and heavy revenue pools are used for those agents who have been awarded those qualities of royalty volumes. Because of the agency relationship the Crown owns a portion of the inventories carried on feeder and trunk pipelines. Trading occurs during the third week of the month prior to delivery ending with trunk pipeline notice of shipments completed around the 19th of that month. As agent, Gulf is responsible for ensuring supply and sales contract fulfillment.
- Sales Proceeds – Collection occurs on the 25th of the month following sale. The royalty share is forwarded to the government at the same time. Share calculations are supply based.
- Reconciliation to Production – In order to ensure the correct amount of oil was delivered to the Crown agents, delivery reports are forwarded to the Crown which are then compared to production volumes reported to our regulatory agency – the Alberta Energy and Utilities Board (AEUB). Over or under deliveries are transacted directly with the facility operator using the agent's netback prices.
- Performance Measurement - Proceeds remitted to the government are compared to performance benchmarks to ensure compliance with the agency agreement.

GULF CANADA'S EXPERIENCE TO-DATE

Background of Gulf

Gulf is a senior Canadian oil and gas producer with headquarters in Calgary, Alberta. Current oil and condensate volumes marketed include:

95,000 bpd	equity
40,000	third party
80,000	Crown royalty as agent
30,000	synthetic oil as agent
245,000 bpd	

In addition, Gulf markets over 500 mmcf/day of natural gas and 15,000 bpd of other NGL's.

Gulf's oil volumes consist primarily of light sweet and light sour crude oil; however our recent acquisition of Stampeder Energy has brought substantial medium and heavy volumes.

Gulf's sales are throughout Canada and the U.S. with its primary markets being Alberta, Ontario, PADD's II & IV, and the Pacific Northwest. At times Gulf has arranged for waterborne shipments into the Far East, California and the U.S. Gulf coast.

Agency Agreement Perspectives

Implementation

Gulf undertook marketing the Crown volumes in June 1996. From a sales perspective, the Crown volumes were easily incorporated into Gulf's sales portfolio since the product types were very similar to Gulf's and the buyers were mostly the same. Most of the APMC contracts were assigned directly over to Gulf resulting in little, if any, supply disruptions to existing buyers.

The only major difficulty encountered was from an internal systems perspective in that systems' upgrades were required to handle the Crown's reporting requirements and the large number of producing batteries from which Crown production was obtained.

As royalty production was delivered in-kind prior to the agents' takeover, there were no implementation hurdles from a Gulf or industry production, marketing and accounting perspective other than having the various feeder and trunk pipelines accept and deliver crudes under a different company.

Prior to privatization, the APMC employed ten staff members in its marketing department. Upon assuming the Crown volumes, Gulf offered employment to four employees including one person to manage the Westcoast policy initiative. The other persons were hired in the supply, accounting and development areas. We have since hired an additional person in the accounting area. Other incremental administration costs were minimal.

Operations

Once the implementation hurdles were dealt with, the day-to-day operational difficulties have been minimal. One of the few recurring problems involves supply forecasting by the facility operators. Significant shortages or overages can cause logistic problems once initial nominations have been made. Although the agent must deal with the outcomes, it has no legal leverage in forcing correct

delivery. We are currently working with the government to design a solution, which may include legislative penalties for incorrect deliveries.
From an administrative perspective we have noticed a slight increase in reporting primarily due to the netback and pooling calculations required. The complexities in managing the Express Pipeline commitment have also added to this increase. We are currently investigating ways to automate the various reporting requirements.

Advantages to the Crown

First and foremost, the move to agency agreements allowed the government to achieve their goal of privatizing while ensuring minimal disruption to industry. In addition, as Gulf has larger volumes to market, we can offer our customers greater flexibility and service thereby enhancing netbacks for both Gulf and the Crown share. This achieves another important goal of the government - revenue neutrality. Thirdly, the move to agents allows the government to retain in-kind royalties, which after exhaustive study, is the simplest and most cost-effective system to administer. Although many of industry's senior and integrated producers will argue in favor of a cash royalty system, this view is taken solely from a volume control perspective. An in-kind system avoids the requirement to deal with all interest owners of a producing facility. As well, the in-kind system avoids a number of pricing implications that can arise in a cash system including streaming or directing certain production to one market versus another and pricing of non-arm's length transactions.

As with the APMC, the current agency relationships allow the government to maintain a window on the marketplace as first-hand market and sales intelligence is available. This is extremely valuable in evaluating development proposals such as new pipelines or oil play developments, preparation for regulatory hearings and ultimately formulating government policy.

Another important advantage to the Crown of an in-kind system is that of undertaking policy initiatives. As the royalty volumes are substantial in amount, the Crown, through its agents, can achieve or foster industry generated solutions by being an active participant. Examples include initiatives to alleviate apportionment on major pipelines and promoting market development. Note that these types of programs can also provide benefits to industry as a whole.

Advantages to Gulf

In addition to providing another revenue stream through marketing fees, the additional volumes have allowed for increased customer service and flexibility as in the case of the government. We were able to implement the move at very little incremental cost thus keeping this new revenue stream in tact.

Other Perspectives

As mentioned previously, given a choice as to the type of oil royalty system to be implemented, Canadian producers would likely be split on the issue. The larger producers and integrateds would probably argue for a cash royalty system to maintain volume control while the smaller producers would likely argue for an in-kind system given its administrative ease.

Although there has been some recent discussion with respect to natural gas royalties in-kind, they have been from a policy initiative perspective such as committing to a take-or-pay obligation on new natural gas pipeline proposals. These discussions never came to fruition. The government has spent substantial sums revising its cash-based natural gas royalty system. One of the major components of the revision has been the conversion from a corporate price base for royalty valuation to a province-wide reference price base. The latter is derived from confidential industry submissions of their monthly gas sales to the government. The Alberta reference price is then netted back to the field for royalty valuation purposes.

Implementation of a gas royalty in-kind system would be very onerous due to the nature of the current sales and transportation commitments. Many of these involve up to ten year contract carriage arrangements and a number of sales to aggregators are based on the life of the gas reserves. All of these situations have committed both the producer's equity share together with the royalty share. It would obviously be a monumental task to just identify these various agreements let alone unwind or assign the obligations on a timely basis. Given the above, it is Gulf's belief that an in-kind natural gas royalty system is not a realistic option in Canada at this time.

Danielle Brian

I appreciate the opportunity to present my views on the Committee's inquiry concerning the proposals to require the Department of the Interior's Minerals Management Service (MMS) to take royalties in kind, rather than in value, which is the current norm. I am the Executive Director of the Project On Government Oversight, since 1981, a non-profit, non-partisan government watchdog group. Our mission is to investigate, expose and remedy fraud, mismanagement and subservience to corporate interests by the federal government.

For the past four years, I have been examining the current federal oil royalty collection program and its astounding failures. I have not had experience looking into gas royalty collections, but I do know enough to know that the oil and gas markets are different enough that one cannot transpose knowledge of oil to the gas market. Over these past few years, it has become crystal clear that the American public, along with all other landowners with oil leases, have been losing out on literally billions of dollars owed to all of us, simply because we were relying on the arbitrary and archaic system of posted prices which undervalues crude oil.

BACKGROUND ON WHY RIK IS BEING PROPOSED:

Since the 1960s in California, there has existed a differential between what the major refiners were posting as a value and what that oil was actually worth on an open market. Since the NYMEX began trading crude oil contracts, it has been clear that a problem exists outside California as well. The problem is that all land owners, including the federal government, have been paid royalties on the lower posted price, rather than on the value of the oil as determined by the open market. Let me emphasize that I am talking about the actual value of unrefined crude oil, the reported prices actually paid for crude oil, and not downstream values.

We believe the companies should be required to pay royalties based on value. The companies should not be required to pay one nickel more than what the crude is worth, but they should pay every penny they owe. The amount owed is set by the open market, which determines the prices, not the phoney posted price system. The NYMEX reports the prices that are paid -- it does not project prices nor is it an index -- it is a reporting of the actual prices companies are paying and receiving. Why shouldn't landowners receive royalties on the values corporate lessees actually received or acknowledged for the crude oil?

While POGO was working to expose this discrepancy, MMS was working, too. In a move that has not been given the accolades it deserves, MMS concluded that relying on the posted price is unworkable, inefficient and most importantly it was allowing billions of dollars to go uncollected across the country.

They came to this decision after the release of their Interagency Task Force that was charged with investigating the existence of the postings/market discrepancy in California. I apologize for the length of this quote from their report, but I believe it is critically important:

> The records discussed below, show California refiners generally preferred purchases or exchanges of California crude oil because, **at prevailing posted**

> **prices, profit margins were much higher than for the ANS (Alaska North Slope) alternative.**
>
> **Therefore, the documents exhibit the extent to which the California oil pricing system, i.e., refiners' posted prices, undervalued California crudes' values to the refiners.** Since these refiners also produced California Federal crude, and to the extent they paid royalty on posted prices, **the royalties they paid did not reflect the value of the crude oil to the company**. In most cases, its real value is never seen in the contract transactions because the crude is either transferred to the refining arm of the company, or it is exchanged with another refiner for replacement crude oil. (emphasis added)

In other words, the companies were not paying the royalties they knew they owed the government. In addition to the use of postings to deliberately underpay royalties, integrated companies often use buy/sell exchanges to hide the true value of crude oil. This is not as complicated a concept as it sounds.

Let's take, for the sake of argument, the production arm of a company called Texxon. They "sell" a barrel of their crude to Shellaco for $10, even though the barrel was worth $12 on the open market. At the other end of the pipeline, the refining arm of Texxon "buys" a barrel of crude from Shellaco for $10. Neither company has lost any money, even though they "bought" and "sold" barrels for $2 below the market price. What they have established, however, is a paper trail for MMS auditors that states that in an arm's length transaction, the price on these barrels was $2 below the market price. These are the kinds of games that these companies play in order to avoid paying the government, and other landowners, what they owe.

So MMS decided to make some changes. This, as you know, is not easy for a bureaucracy to do. They recognized the need to streamline and make more efficient the royalty collection process, so they recommended moving to the market-based valuation system as reported by the NYMEX for East of the Rockies, and Alaska North Slope for California. This is the system the integrated major oil companies use to value their own oil internally, and of course, these are the prices being paid on the market. Not surprisingly, Big Oil raised its head. Until then, these majors had been quite silent through this debate.

Now they realized these improvements to the system -- which I note have not yet been finalized or implemented -- will result in their having to pay the federal government more in royalties. Not surprisingly, they did not like what they saw.

Law firms and economists were suddenly paid to deluge MMS with criticisms of their proposed new rule. It should not come as a surprise to us that industry does not want to have to pay what it owes for producing on public land -- it has been getting away with cheating the public for decades.

These efforts have produced two baseless lies which have, unfortunately, shaped this debate: The first lie is that RIK would be better for smaller independents, because MMS' proposed Rule is too burdensome for them, or that they would have to pay royalties on prices they did not receive. MMS' recent revision to its proposed Rule makes this argument baseless. That is, the revised rule allows them to pay royalties on their receipts, not a value derived from NYMEX prices. Simply put, the trade associations that purport to represent the interests of small independent oil producers are doing their members a great disservice by creating this aura of fear around the new Rule.

The second lie is that paying royalties on the value of the crude imposes an unfair "duty to market." This is a sham. They have always had a duty to market. For example, the existing rules, put into effect in 1988, state that a lessee has a ". . . duty to the lessor to market the production for the mutual benefit of the lessee and the lessor. . ." and provides that MMS may take over the valuation computation if this is not done. The new Rule allows for the deduction of location and quality differentials. The myth of additional "value" added by marketers to the crude, over and above these differentials, is a fig leaf industry is hiding behind so as not to admit they should have been paying royalty owners higher royalties all along.

The methodology used by MMS to determine location differentials, i.e. the differentials used by the companies in making exchange agreements, would subsume all other costs if they existed. Of course, we don't believe they do exist.

To demonstrate this point, before 1986 spot and posted prices East of the Rockies tracked each other quite closely, once one accounted for transportation. Therefore, obviously there was no added value between the wellhead crude and the crude at the market. Now, with a persistent differential between spot and posted prices, there is no reason to attribute it to a purported marketing cost. Rather, it is an indication of the undervaluation of the crude.

The point is also demonstrated by the fact that a number of large independent producers are getting prices that are tied to the NYMEX.

WHY A NATIONWIDE RIK PLAN IS NOT IN AMERICA'S BEST INTEREST:

Ironically, industry's proposed RIK plan in some ways would not be very different from what we currently have. We are already relying on private marketers to get the best price available for the crude produced on federal land. We simply have not been sharing in that value. This system has not been good for the federal government, or any other land owners.

One reason industry's RIK plan is not in America's best interest is that it will most likely result in royalties based on posted prices. The marketers of the government's oil would make their profit by collecting the difference between postings and market prices -- they would buy the government's oil at postings, and sell it at the market price. On the other hand, under the proposed Rule, this difference would all go to the government, except in arm's length contracts involving small independent producers, who themselves, may not be receiving full value.

Independents have suffered under the posted price system along with the federal government, and other landowners. As characterized by one industry association, independents are "price takers" not "price setters." Like independents, MMS would be trying to sell even smaller quantities of crude. MMS' feasibility study notes that even the marketers do not see any benefit from aggregation of federal oil, assuming aggregation is possible. The lack of access to transportation to the market drains all of us our bargaining position at the wellhead.

But instead of improving the situation for independent producers, the RIK program locks the federal government into the same powerless condition where we must accept whatever price is offered to us by the companies that control or own local pipelines. And guess where we end up? Back at posted prices.

According to Louisiana's testimony, the potential savings we may see by reducing administrative costs, are likely to be largely offset by the marketing experts who would need to be hired by the government to handle the RIK oil.

More significantly, the potential administrative savings would likely amount to only a fraction of the royalties we would collect if we implement the new Rule. The total operating expense of MMS is $60 million annually. The proposed Rule is estimated to increase MMS' revenue by at least $100 million annually. Even if the RIK plan allowed us to completely eliminate MMS (which it couldn't as MMS is responsible for much more than just crude oil royalty collection), the government would <u>still</u> have to collect increased revenue of more than $40 million annually to be as effective as a NYMEX value system.

In MMS' feasibility study, however, they stated ". . .despite direct inquiries, marketers were not able to provide convincing arguments or evidence that oil RIK would be revenue positive."(p.16) If even the people who would stand to make a profit off the RIK plan cannot show that the government would be any better off with it, why on Earth should we do it?

We have heard today how effective the RIK program is in Alberta. There are enough fundamental differences in the relationship between government and industry in Alberta that their system could not be transposed to the United States. I submit that our industry would not be as enthusiastic about R-I-K if it were subject to such restrictions as exist in Alberta.

THE PLIGHT OF INDEPENDENTS:

I understand from your earlier hearing on this subject that Rep. Dooley is particularly concerned about the impact of MMS' new rule on the independents. I am also concerned about the impact on small independents, and it is quite clear that MMS has been too. In response to the IPAA's concerns, MMS revised the Rule to more than compensate for their unique situation. If the independents do not have access to transportation to the market, as is true in California; if they are captive sellers, the MMS has proposed that these companies may pay royalties based on what they received for the crude.

WE SHOULD NOT REINVENT THE WHEEL:

Other land owners across the country — States, private land owners and Native American tribes — are rising up, in some cases filing law suits, and demanding payment based on value — the full value owed to the land owners. The State of Texas, which testified at your recent hearing, has completed a settlement with Chevron. Private royalty owners in Alabama are currently settling with Mobil. ARCO is paying New Mexico. All of these States are being paid royalties based on the NYMEX. The State of Louisiana is being paid by all leaseholders based on the spot prices at St. James. These States have testified that given the choice, they have rejected RIK programs in favor of being paid on the value of the oil. The Federal government should learn from the decisions being made by States across the country not to use RIK.

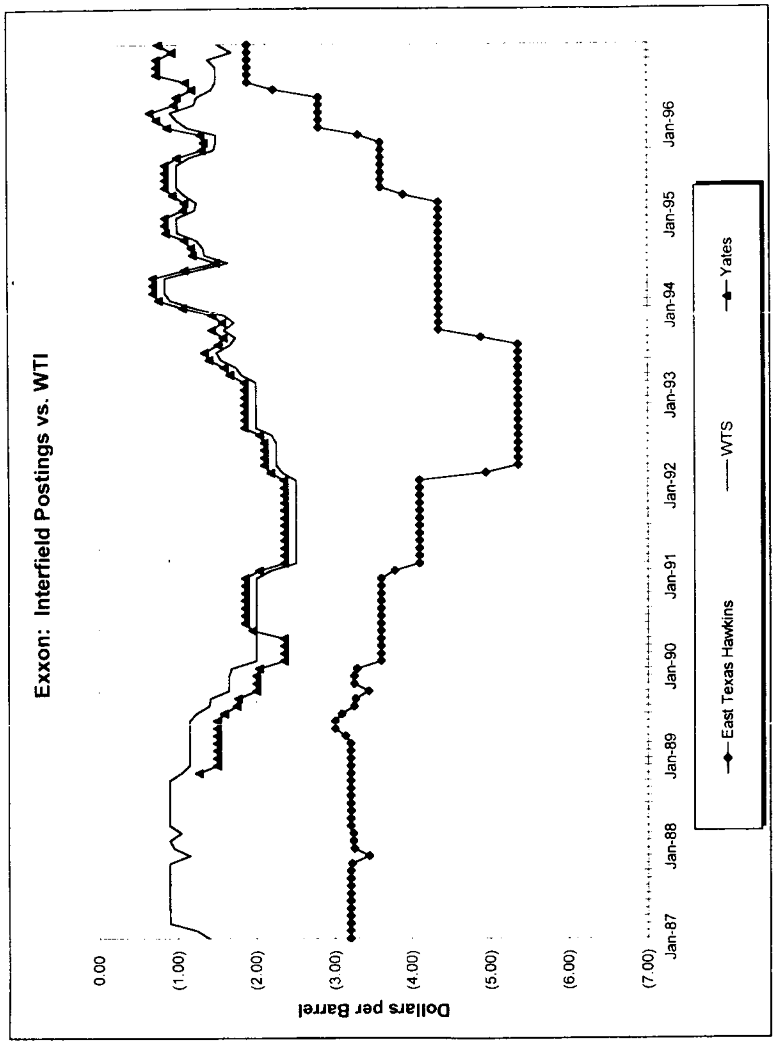
There may very well be unique circumstances where RIK could work. This does not mean, however, that MMS should accept a voluntary plan, where companies can dump on us their poor quality, small quantity or difficult to transport crude, they would rather not have to deal with.

I am sure it is not lost on you that industry is in favor of RIK. Of course they are. They are interested in their bottom line, not ours. You can't blame them for trying, but we certainly shouldn't let them get away with it.

FOLLOW-UP ADDRESS

Danielle Brian
Executive Director

Project On Government Oversight
1900 L St., NW, Suite 314
Washington, DC 20036-5027
(202) 466-5539



All prices are monthly averages

Oversight Hearing on Royalty-In-Kind (R-I-K) Program
For Oil and Gas Production from U.S. Federal Leases

Subcommittee on Energy and Mineral Resources of
The Committee on Resources

U.S. House of Representatives

September 18, 1997

Presented by Richard G. Rorschach, Chairman
National Association of Royalty Owners, Inc.

Good afternoon, Chairman Young and members of the committee. I am Richard Rorschach, a lawyer with more than 35 years in the practice of oil and gas law. I live in Kilgore, Texas. I am the Chairman of the National Association of Royalty Owners. I wish to address my comments today to the mineral and royalty owners' interests in and concerns about the changes to the current cash-based collection system of royalty owner payments.

My organization, the National Association of Royalty Owners, has nearly 5,000 members residing in 47 of the 50 states. Additionally, NARO has been active with over five leading Indian tribes, including the Navajo, Apache, Sac and Fox, Osage and Chickasaw. NARO is dedicated to the needs of the nation's more than 4,500,000 mineral and royalty owners. A large number of our members are 70 years of age or older. Many of us still live in a rural setting. A great many of us rely on our royalty income as a vital supplement to our social security payments. Many rural communities still find royalty income their economic lifeline. Royalty income also still enables many, many of our farms and ranches to survive the ravages of Mother Nature. An oil country banker once called the royalty income of these farmers and ranchers "the financial heartbeat of the heartland." So whatever affects the over 4,500,000 mineral and royalty owners has a significant effect upon our elderly and those of us in need of additional income.

I appeared in Houston, Texas, at a Minerals Management Service public meeting on April 17, 1997. A copy of my comments on the MMS proposed rule establishing oil value for royalty due on federal leases and on sale of federal royalty oil is attached.

Let me tell you how I, as a royalty owner, and the other members of NARO view changes to the current cash-based collection system in the payments to royalty owners. We have wrestled with the problem of "posted prices" for years. The industry, in recent years, has been in disarray on the policy of pricing. I am advised that in the oil and gas producer-purchaser transaction there are at least

200 factors which go into each very complicated pricing decision. Recently, several lawsuits have been filed to protest the use of "posted prices" as a basis for royalty payments, the most publicized of which is probably the General Land Office of Texas vs. Amoco, Chevron, Exxon, Marathon, Mobil, Phillips, Sun, and Texaco. Union Pacific has been added since the original suit was filed (the Union Pacific lawsuit is in Fayette County, Texas, while the main suit is filed in Travis County, Texas). These suits, and others like them, will, in my opinion, put the nails in the coffin of "posted prices." There will be a different method used to determine the "fair market value" of the production on which to base royalty payments. The question is "What is the best method?"

The best method, in my opinion, is the one which most easily determines the "fair market value" of the production with the least amount of paperwork. If the paperwork, including calculations and reporting requirements, becomes burdensome, the independent producer (and in some cases, the major producers) will simply plug the marginal wells on its federal lease. I am advised that the Federal Government has about 61,000 producing wells. Of these nearly 46,000 are marginally producing or low volume wells. If these wells are shut-in because of onerous administrative requirements on the producer, we, as nation, stand to lose nearly 140,000 barrels of oil production per day. And remember, any loss of domestic production, from Federal leases or private leases, will result in additional importing of foreign oil. (Reliance on foreign oil has been reported by the Commerce Department to endanger our national security.) Then, let us not overlook the paperwork burden on Washington. Recall the days of the Federal Power Commission when pipelines were required to submit pricing requests. Truckloads of submissions were sent to the FPC and were stored in warehouses untouched. Finally, the FPC was required to issue temporary pricing structures until the original applications could be examined. Many never were. Would we be looking at a similar situation if voluminous reporting requirements are placed on producers?

Today the average "mom and pop" business in the oil field is the operation of marginally producing or low volume wells. These operators are now totally over their heads with regulations and federal environmental requirements. In southeast Oklahoma, one of our key producing areas, I am advised that many marginally producing or low volume wells are being needlessly plugged and abandoned because the operators are no longer able to keep up with the reporting requirements and still make a profit. Will we experience this type of waste on Federal leases with yet additional paperwork?

How do we avoid a mass of paperwork and receive "fair market value" for our royalty? Royalty-In-Kind may just be the solution. Some years ago the Texas Railroad Commission held monthly meetings where purchasers nominated the amount of crude oil needed for their operations for the following month. The meetings were held in Austin, Texas, and lasted perhaps 2-3 hours. After the nominations, the TRC set the monthly production for the following month. This method worked fairly well. Possibly with an R-I-K program the MMS could hold similar meetings in various districts of the US where purchasers could bid on Federal oil for the following month.

These auctions would be open to any qualified purchaser and would ensure a realistic market value for the product. Obviously, the successful purchaser would consider all factors which make up the price of the product when making a bid. The MMS would realize the maximum market price for the product. Paperwork would be at a minimum. No additional personnel would be required at the MMS to process this procedure.

I understand that Canada has an R-I-K procedure. Thirty-three Canadian employees market 146,000 barrels per day of Canadian oil under this method. Further, I have been advised that the MMS has jurisdiction over 204,000 barrels of oil per day. The MMS has 950 employees. Surely we can perform as well as our Canadian neighbors.

As a royalty owner with production from any one lease averaging no more than 2-3 barrels of oil per day (this is probably representative of at least 75% of NARO membership) taking royalty-in-kind is not an alternative. We must rely on our producers to market our production for us under the terms of our oil and gas leases. Our leases, like those of many Indian tribes, have grown increasingly more sophisticated over the past few years. We rely on and believe that our transactions, present and future, should be governed by our lease language, not by rules and regulations coming from others who know very little of our industry or our operations. Our lease language has evolved so that we are now getting what we believe to be a "fair market value" for our production. The goal of the National Association of Royalty Owners is this:

"The establishment of fair, accurate, and workable pricing and reporting practices to the end that a 'true' value for basing royalty calculations can be determined."

We in NARO think that an R-I-K program, where feasible, will meet this goal.

This concludes my remarks. I thank the committee for the opportunity to appear here today.

COMMENTS
Proposed MMS Rule
Establishing Oil Value For Royalty Due On Federal Leases
And On Sale Of Federal Royalty Oil

-- by Richard G. Rorschach, Kilgore, Texas
Chairman, National Association of Royalty Owners

As a beginning comment, it is obvious, considering the political climate at the MMS and other places in Washington, D.C., that a rule will be promulgated which will establish oil value for royalty due on Federal leases and on sale of Federal royalty oil.

The intent of the proposed rule is to "add more certainty to valuation of oil produced from Federal lands and eliminate any direct reliance on posted prices." This is a problem which the domestic industry has wrestled with for years. Recently, several lawsuits have been filed to protest the use of "posted prices" as a basis for royalty payments. the most notorious of which is probably the General Land Office of the State of Texas vs. Amoco, Chevron, Exxon, Marathon, Mobil, Phillips, Sun, and Texaco. I think Union Pacific has been added since the original suit was filed.

Under the proposed rule, two types of sales would be recognized:

1) the arm's length resale price, and
2) the monthly average of the NYMEX

It is apparent from the definitions that the MMS considers that very few, if any, sales will be made as arm's length transactions. The method specified in the proposed rules using the monthly average of the NYMEX is so complicated that a producer, other than possibly a major, will not economically be able to comply. The paper work alone would be disastrous. Faced with the calculations and the reporting requirements of the proposed regulation, the independent (and in some cases, the major producers) will simply plug the marginal wells on its Federal lease(s). I don't know the volume of marginal well production from Federal leases, but any loss of domestic production, from Federal leases or private leases, will result in additional importing of foreign oil. (Reliance on foreign oil has been reported by the Commerce Department to endanger our national security.)

Then consider the volume of paperwork which would be sent to Washington. Recall the days of the FPC when pipelines were required to submit pricing requests. Trucks unloaded in Washington with the submissions. They were stored in warehouses untouched. Finally, the FPC was required to issue temporary pricing structures until the original applications could be examined. Some, (many?) never were. Are we looking at a similar scenario? As an example, consider the language on page 48 of the proposed regulations.

"MMS has included a copy of proposed Form MMS-4415 as Attachment A to these proposed regulations. Information submitted on the new form would cover all of the lessee's and its affiliate's crude oil production, and not just information related to Federal or Indian lease production." *(emphasis added).*

MMS will need an untold number of new employees to catalogue this mass of production information.

Then consider the confusion in reporting using the NYMEX value, as adjusted per the proposed regulations. With so many factors involved in the pricing of crude oil the seemingly simple calculations illustrated in the proposed rules will not result in a true market value for the product. The affected producer may well wonder what will be the punishment if the value is calculated incorrectly! And when will the incorrect calculation be discovered? What will be the penalty? How long will it take the statute of limitations to run?

What, then, might be a more simple method requiring little paper work and a more certain market value of the product?

Some years ago the Texas Railroad Commission held a monthly meeting where producers nominated the amount of crude oil needed for their operations for the following month. The meeting was held in Austin, Texas, each month and lasted perhaps 2 - 3 hours. After the nominations, the TRC set the monthly production for the following month. This method worked fairly well. Perhaps the MMS could hold similar type meetings in various districts of the US where purchasers could bid on Federal oil for the following month.

These auctions would be open to any qualified purchaser and would ensure a realistic market value for the product. Obviously, the successful purchaser would consider all the factors which make up the price of crude oil when making a bid. The MMS would realize the maximum market price for the oil. Paperwork would be at a minimum as would any exposure to the purchaser for penalties incurred for calculating an incorrect price. No additional personnel would be required at the MMS to process this procedure.

Written Statement
of
Edwin S. Rothschild
Energy Policy Director
Citizen Action
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
September 18, 1997

Dear Madam Chairwoman and Members of the Committee:

My name is Edwin S. Rothschild, Energy Policy Director of Citizen Action, a nationwide consumer organization with members in 31 states. Citizen Action has been involved in energy issues since its founding in 1978. I have worked as a consumer advocate on energy issues since 1972.

We are here today to discuss proposals for the federal government to take its oil and gas royalties in kind. Before examining such proposals in detail, we would like to make several observations that bear directly on this issue.

We note, first, that oil and gas industry efforts promoting royalty in kind began in earnest only after the Minerals Management Service ("MMS") proposed changing the valuation method for the collection of royalties on oil and gas produced from federal onshore and offshore lands. It is strange, to say the least, that for 75 years oil and gas leaseholders had no burning desire for a royalty in kind system and were content with a system of posted prices. When questions began to be raised about the posted price system and when proposals were advanced to go to a system using prices based on the competitive marketplace, then royalty-in-kind suddenly had some appeal. Moreover, having spent a great deal of time and effort in opposing the federal government's sale of the prolific Elk Hills oil field, we are struck by the irony of the industry now wanting to get the government into the oil business, after arguing vociferously about the need to get the government out of the oil business.

As a consumer organization, we are really not wedded to any one system of collecting federal oil and gas royalties as long as those methods or systems chosen ensure that the public, which own the resources, receive the maximum revenues to which they are legally entitled under existing economic conditions. Moreover, as Members of Congress you have the very important duty of examining and reviewing such proposals very closely because, as elected government officials, you have a fiduciary responsibility to ensure that the public, that is the U.S. Treasury, obtains full value for their property.

We also would like to note that significant structural changes in the oil and natural gas marketplace must be recognized when considering various royalty proposals. For example, over the past 25 years the oil industry has undergone enormous consolidation. A veritable handful of companies produce most of the oil on federal lands. Those same producers are also the nation's largest oil refiners. In these companies, oil and gas production almost always goes through one or more transfers within the companies before it is sold, exchanged, or refined by the companies. There is no such thing as an arms-length transaction between affiliates or subsidiaries of the same parent company. Furthermore, the large companies rarely sell oil outright; they almost always exchange away what they do not keep for their own use. Since most of the oil produced on federal lands is produced by large, vertically integrated oil companies and since there are now only a small number (and likely soon to be even fewer) of those companies in the marketplace, a real market price transaction does not exist on which to base federal royalties, or state royalties for that matter. Therefore, MMS's proposal to use NYMEX as the base upon which market prices can be determined not only makes economic sense, but is highly appropriate.

This is not to say that royalty in kind should never be used. On the contrary, it may make sense in a number of instances -- selling offshore volumes of natural gas, for example. However, we would strongly urge the Committee not to accept the clearly self-serving comments of oil and gas industry executives that royalty in kind should be applicable to any and all leases, especially not on a voluntary basis, as a few have suggested. Rather, we urge the Committee to examine the industry's views under a clear and powerful microscope keeping in mind that it is highly unlikely that oil and gas producers would promote a policy that would actually increase government revenues at their expense.

In your letter of invitation, Madam Chairwoman, you asked about the connection between structural changes in the oil and gas industry and the implementation of a royalty in kind collection program. We believe that there is sufficient evidence to conclude that consolidation in the oil and gas industry and the lack of effective competition in some key markets could undercut a royalty in kind program.

Tables 1 and 2 below indicate how the ten largest oil producers in the nation have remained remarkably stable over time, despite the sharp decline in the overall number of producers and the overall decline in domestic petroleum output. In 1982, the *Oil & Gas Journal* proudly remarked, "The mere compilation of the OGJ 400 demonstrates the immense size and diversity of the petroleum industry." Yet, in a few short years, this number would be whittled down, in part because of changing economic conditions and in part because of a spate of mergers and acquisitions. Gulf was devoured by Chevron; Mobil acquired Superior; Texaco bought out Getty; Sohio was captured by British Petroleum. There were many others, but these were some of the largest consolidations during the 1980s. By 1991, the *Oil & Gas Journal* had to report that it's once proud OGJ 400 had become the OGJ 300, because "industry consolidation has slashed the number of public companies." And, again in 1995, the *Oil & Gas Journal* reported that the OGJ 300 had shrunk down to the OGJ 200. "Mergers, acquisitions, and other forms of consolidation have again shrunk the Oil & Gas Journal list of publicly-traded oil and gas producers in the U.S." Today, the consolidation of oil producers continues. The production units of Shell and Mobil, for example, have joined forces in California,[1] and Texaco recently purchased Monterrey Resources for $1.4 billion.[2]

Industry consolidation also has taken place at the oil refining and marketing levels of the industry. The disappearance of independent refiners and marketers and the combination of some of the nation's largest integrated oil companies has sharply reduced the number of domestic oil purchasers. With fewer domestic crude oil purchasers, there is less overall competition, that is, fewer bidders for the remaining supplies that are sold into the open market. Similarly, there is also growing consolidation in natural gas and electricity markets. Such combinations include pipelines buying pipelines; gas companies buying electric companies; electric companies buying gas companies; and electric companies buying electric companies -- all with an eye to controlling delivery of Btus and kilowatts from production or generation to the burner tip. The growing concern by the remaining small and some large independent oil and natural gas producers about wellhead prices for oil and natural gas has a lot to do with this growing consolidation in the oil and natural gas markets. In some regions, independent producers have been forced to sell at much lower prices because purchasers control the only means of moving the product from the field to market.

Table 1 traces the changes in oil (liquids) production as reported in the industry trade publication, *Oil & Gas Journal*, for the years 1982-1996. It clearly demonstrates that Exxon, BP, Arco, Shell, Texaco, Chevron, Mobil and Amoco have dominated U.S. oil production. Not surprisingly, these are the same eight companies which are among the ten largest payors of oil and gas royalties (Table 3) to the U.S. Government paying 61% of all onshore and offshore royalties paid for oil. Moreover, as Table 3 also shows, these same companies pay a much smaller part of the royalties on natural gas production (42%) suggesting that production is dispersed among more companies, including many independents.

Table 1

United States Liquids Production (000 bbls)																
Year	Exxon	BP/ Sohio	Arco	Shell	Amoco	Texaco (Getty)	Chevron (Gulf)	Gulf	Mobil (Supr)	Getty	Sun/ Oryx	Phillips	USX	Unocal	Top 10	Top 400 300, 200
1982	270000	253200	222000	190000	151000	127000	121000	104000	103000	102000					1643200	NA
1983	285000	223800	238000	191000	149000	124000	116000	100000	102000	104000					1632800	2357300
1984	285000	232000	240000	195000	149000	210000	115000		113000		71000	62000			1539000	2239378
1985	281000	262300	237000	193000	144000	233000	214000		120000		71000	68000			1684300	2417010
1986	278000	263100	240000	209000	142000	215000	199000		114000				63740	63000	1660100	2360400
1987	276000	309000	243000	204000	142000	197000	185000		112000		59000			63000	1668000	2343500
1988	278000	314000	246000	193000	149000	192000	177000		111000		57000			64000	1660000	2312600
1989	253000	286000	241000	180000	142000	175000	176000		107000		53000			63000	1560000	2145100
1990	234000	269000	233000	168000	127000	167000	167000		102000		51000			52000	1467000	2029000
1991	266000	269400	244000	167000	116000	166000	166000		121000			47000		57000	1515400	2094000
1992	216000	251800	242000	163000	107000	158000	158000		114000			50000		47000	1409800	1967000
1993	202000	228900	221000	147000	100000	155000	144000		111000			47000		48000	1308900	1877000
1994	206000	220800	216000	151000	93000	148000	134000		110000			45000		50000	1278800	1854000
1995	219000	209000	213000	161000	88000	139000	129000		103000				48180	46000	1261000	1828000
1996	214000	206000	205000	165000	92000	142000	125000		96000			37000	45000		1245000	1820000

Source: *Oil & Gas Journal*, various issues.

Table 2

Liquids Production By Top 10 Companies And As A Percent of Top 400, 300, and 200 1982-1996 (000 bbls)			
Year	Top 10 Companies	Top Companies	Percent Top 10
Top 400			
1982	1643200	NA	NM
1983	1632800	2357300	69%
1984	1539000	2239378	69%
1985	1684300	2417010	70%
1986	1660100	2360400	70%
1987	1668000	2343500	71%
1988	1660000	2312600	72%
1989	1560000	2145100	73%
Top 300			
1990	1467000	2029000	72%
1991	1515400	2094000	72%
1992	1409800	1967000	72%
1993	1308900	1877000	70%
1994	1278800	1854000	69%
Top 200			
1995	1261000	1828000	69%
1996	1245000	1820000	68%
Source: *Oil & Gas Journal*, various issues.			

Table 3

Top Ten Royalty Payors - 1996			
Company	*Oil*	*Gas*	*Total*
Shell	$193,043,793	$168,662,408	**$361,706,201**
Chevron	$158,395,170	$158,965,381	**$317,360,551**
Exxon	$156,756,227	$91,998,760	**$248,754,987**
Texaco	$88,826,287	$122,995,288	**$211,821,575**
Mobil	$63,808,900	$78,760,205	**$142,569,105**
Amoco	$41,649,258	$96,934,509	**$138,583,767**
Union	$39,437,517	$93,051,833	**$132,489,350**
Arco (Vastar)	$42,204,665	$63,248,893	**$105,453,558**
Marathon	$57,008,595	$34,782,074	**$91,790,669**
BP	$42,826,430	$9,721,547	**$52,547,977**
Top Ten Total	$883,956,842	$919,120,898	**$1,803,077,740**
U.S. Total	$1,452,092,920	$2,175,636,703	**$3,627,729,623**
Percent Top Ten	61%	42%	**50%**
Source: Minerals Management Service.			

Before analyzing and assessing the applicability and feasibility of a royalty in kind program for use on federal oil and gas leases, it is important to ask why, suddenly, the industry is making such an intense effort to persuade you and the Interior Department to move to such a program? First, we think it is important to recognize recent state and federal efforts to collect underpayments of royalties from previous production, the value of which was tied to posted prices. As recently reported by *Business Week*, "The current wave of oil royalty litigation was prompted, in large part, by eye-popping judgments against the industry. In 1992, for example, the state of California received a settlement of $350 million from seven large oil companies after a two-decade struggle. And in 1994, Alaska recovered $3.7 billion."[3] Furthermore, on behalf of the state of Texas and private royalty owners, Texas filed a lawsuit in 1995 against eight oil companies. The first company to settle the suit was Chevron which agreed to reimburse the State and the other royalty owners $17.5 million for payments going back to 1986. In addition, Chevron also agreed to a new valuation formula based on prices for West Texas Intermediate crude oil as reflected on NYMEX for all production after January 1, 1997. On December 20, 1995, the MMS published an Advance Notice of Proposed Rulemaking about possible changes to the rules for royalty valuation from Federal and Indian leases. As explained by MMS, "The intent was to decrease reliance on oil posted prices and to develop valuation rules that better reflect market value."

The decision to move away from artificial, non-market based posted prices set off volcanic tremors and tectonic movement from Houston to Casper. This shift from posted prices to market-based prices would clearly enhance federal and state revenues and sharply reduce the need for complex audits of intricate intra-company and other transactions. We also note that both large integrated and large independent companies tend to refuse MMS auditors access to trading affiliates' records. Clearly, without appropriate records, it becomes difficult, if not impossible, to track pricing transactions.

Ironically, even though NYMEX is being proposed by MMS as the base on which to calculate the price at the lease (after adjusting for location and quality), some in the oil industry are claiming that NYMEX prices do not accurately reflect the market. A reading of oil company 10-K filings to the Securities and Exchange Commission, however, clearly shows that most large companies, integrated and independent alike, report that they use NYMEX to hedge their own oil and gas sales. By doing so they show utmost confidence that changes in NYMEX prices go right along with changes in local prices directionally and in absolute terms. Otherwise, why would they use NYMEX? On this critical point, what should the Committee believe: what the companies tell their shareholders on their 10-Ks, or what they tell the government about a change that will help to correct royalty underpayment.

Clearly, from the point of view of the public trust, MMS was moving in the right direction, especially with regard to dealing with the problem of non-arms length transactions. Because most of the transactions on federal oil leases are not arms-length, there is no competition. The transaction is between affiliates or subsidiaries of the same company, usually the production arm selling to the trading arm or to the refining arm. Thus, if there is no competitive market price, how can the public obtain fair market value without engaging the government in long-term, complex audits? Substituting an RIK program on offshore oil sales for the collection of royalties based on NYMEX is of dubious value. Who else, for example, other than Shell, is going to purchase oil from Shell's billion dollar Cognac field in the deep waters of the Gulf? Shell clearly expects to obtain all the oil produced on that lease to feed its refinery in Louisiana. Thus, implementing an RIK program on such leases is very likely to cost the government money -- money to pay for hiring a knowledgeable marketing firm as well as other experts and because there is little evidence to suggest other buyers would come a calling. Of course, the government could refuse to sell to Shell until Shell paid what the government thought was fair, but then Shell would probably complain that the government is taking unfair advantage and should be prohibited from such activity. Based on the structure of the market and the fact that the bulk of royalty oil production is in areas where competitive arms-length transactions are limited at best, we believe that an RIK program would not yield as much revenue to the Treasury as basing the royalty on NYMEX prices adjusted for location and quality.

With regard to natural gas, however, an RIK program might be worthwhile. Certainly, it is worth conducting additional pilot programs to test this hypothesis. Following the deregulation of natural gas markets and with the beginning of deregulation in electricity markets, there is some reason to believe that large volumes of natural gas from the Gulf of Mexico could command market prices sufficiently higher than current levels. Of course, in order to work, an RIK program cannot be operated on a voluntary basis as some in the industry have argued. The government must have the authority to take as much of its royalty gas as it deems necessary to obtain fair market value.

While there may be some reasons to consider RIK programs in onshore areas, it is impossible for the federal government to move forward unless the states do so as well. At this point in time, while we understand Wyoming is moving forward and Texas has made some efforts in the area, neither California, nor Louisiana seem to be interested in such a program.

We'd also like to comment on several issues that have been raised by the companies promoting RIK. Many of their spokesmen make a big issue out of the costs of government oversight and auditing. According to the MMS, the annual costs of administering the entire royalty system is $66 million, of which approximately $20 million is used for audits. The audits, at least since 1982, have generated approximately $125 million a year in revenue. Thus, for every dollar spent, the government gets about six. Secondly, industry spokespeople ignore the fact that there are costs associated with implementing an RIK program, not the least of which, is paying and overseeing marketers hired to sell the government's royalty oil or gas.

We also think it is curious that smaller independent oil and gas producers are complaining loudly about the proposed royalty system when they are likely to do far better financially under such a system than they do now. The fact is that, at least with respect to oil, smaller independents receive the posted price for all their production, rather than the higher NYMEX-based price. Such a system primarily benefits the major integrated oil and large independent companies at the expense of smaller independent producers. Instead of criticizing MMS, we believe the smaller independents ought to be thanking the agency. According to the MMS's supplementary proposed rule, smaller independent producers will, for the most part, not be even subject to NYMEX-based prices, assuming they engage in arms-length competitive transactions. For such transactions, they would be allowed to use gross proceeds paid.

Finally, we believe it is important to point out that a number of oil and gas industry spokespeople have criticized the concept of "Duty to Market," claiming that there are some vaguely defined "costs," beyond legitimate location and quality adjustments, associated with moving oil or gas from the lease. Historically, producers have always marketed royalty production. They have an impled common law duty which has been legally upheld. Any attempt to alter this relationship could result in a breech of contract. Since contractual relationships undergird all of the government's oil and gas leasing arrangements, such a breech of contract, even if legislatively mandated, could result in extensive litigation.

In summary, we believe that whatever royalty program is adopted or used by the MMS, it must result in prices determined by competitive market forces and in fair market value. We believe with respect to transactions regarding oil leases which are not competitive and not arms-length, that prices be determined on the basis of NYMEX adjusted for location and quality. We believe it is reasonable to proceed with additional RIK pilots, especially with respect to natural gas, since it appears that market conditions may be more favorable, especially in the Gulf of Mexico, for such a program. Finally, we also think it makes sense to carry out additional pilot programs for oil and gas onshore, but recognize it can only work in states that are also willing to implement such a program.

NOTES

1. "Shell Affiliate CalResources and Mobil Complete Definitive Agreements on California E&P Company," Shell Press Release, June 2, 1997.

2. "Texaco to Buy Monterey Resources for $1.4 Billion in Stock and Debt," *Los Angeles Times*, August 19, 1997.

3. "A Royalty Pain for the Big Oil Companies," *Business Week*, September 1, 1997.

Supplemental Sheet

Edwin S. Rothschild
Citizen Action
1900 L Street, N.W.
Suite 602
Washington, D.C. 20036
(202) 775-1580

ROYALTY-IN-KIND FOR OIL AND GAS PRODUCTION FROM U.S. FEDERAL LEASES

TESTIMONY OF:

LINDEN C. SMITH
MANAGING DIRECTOR
BARENTS GROUP LLC
A KPMG COMPANY

BEFORE THE

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
COMMITTEE ON RESOURCES
UNITED STATES HOUSE OF REPRESENTATIVES

ON BEHALF OF:

AMERICAN ASSOCIATION OF PROFESSIONAL LANDMEN
AMERICAN PETROLEUM INSTITUTE
COLORADO OIL AND GAS ASSOCIATION
DOMESTIC PETROLEUM COUNCIL
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
INDEPENDENT PETROLEUM ASSOCIATION OF THE MOUNTAIN STATES
INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO
MID-CONTINENT OIL AND GAS ASSOCIATION
MONTANA PETROLEUM ASSOCIATION
NATIONAL OCEAN INDUSTRIES ASSOCIATION
NATURAL GAS SUPPLY ASSOCIATION
NEW MEXICO OIL AND GAS ASSOCIATION
NORTH DAKOTA PETROLEUM COUNCIL
NORTH TEXAS OIL AND GAS ASSOCIATION
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
PETROLEUM ASSOCIATION OF WYOMING
ROCKY MOUNTAIN OIL AND GAS ASSOCIATION
ROCKY MOUNTAIN OIL AND GAS ASSOCIATION – COLORADO
TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION
UTAH PETROLEUM ASSOCIATION
WYOMING INDEPENDENT PRODUCERS ASSOCIATION

SEPTEMBER 18, 1997

My name is Linden C. Smith, and I am a Managing Director of Barents Group LLC, a KPMG Company. I lead the Firm's Legislative and Regulatory Policy Practice. I am here today to discuss how a permanent royalty-in-kind program can provide a net benefit to the Federal Government, the states, and lessees, and more specifically, to focus on the federal policy and budgetary implications of an RIK program. I appear today on behalf of the following 21 industry trade associations:

American Association of Professional Landmen
American Petroleum Institute
Colorado Oil and Gas Association
Domestic Petroleum Council
Independent Petroleum Association of America
Independent Petroleum Association of the Mountain States
Independent Petroleum Association of New Mexico
Mid-Continent Oil and Gas Association
Montana Petroleum Association
National Ocean Industries Association
Natural Gas Supply Association
New Mexico Oil and Gas Association
North Dakota Petroleum Council
North Texas Oil and Gas Association
Oklahoma Independent Petroleum Association
Petroleum Association of Wyoming
Rocky Mountain Oil and Gas Association
Rocky Mountain Oil and Gas Association – Colorado
Texas Independent Producers and Royalty Owners Association
Utah Petroleum Association
Wyoming Independent Producers Association

A description of these organizations is contained in Attachment 1. These associations represent producers of essentially all of the oil and gas produced in the U.S. – including the Gulf of Mexico, the Rocky Mountains, Wyoming, New Mexico, California, and all the other states with production on federal lands.

Before joining Barents Group in 1987, I was on the staff of the congressional Joint Committee on Taxation for 11 years and with the U.S. Treasury Department and the Internal Revenue Service for 4 years as an economist and revenue estimator. During 15 years of Federal Government score-keeping experience, I was responsible for developing federal budgetary impact estimates of numerous legislative provisions affecting the IRS, business taxpayers in all industries, and especially in the oil and gas industry. During the past 11 years, I have performed similar work for government and private sector clients, with a significant share of this work in the energy area. In addition to my representation today, Barents has also been retained to comment on MMS' proposed crude oil valuation rule and has recently filed three sets of comments with MMS and the Office of Management and Budget on behalf of industry associations.

I would like to address two issues today. First, I will discuss the attributes of a well-designed royalty system. That is, if we could step back from the practices and biases of the current system, what would we want a more effective and efficient replacement system to accomplish? Second, I will discuss revenue considerations critical to the design of any replacement system. Clearly, any serious legislative alternative will need to be revenue neutral. While an RIK program is not the only approach for addressing the many concerns raised by the current system, it could be the approach that best satisfies what I would suggest are objective requirements for a good royalty system, while accomplishing the revenue neutrality objective.

Characteristics of a good royalty system

Needs to be market driven. The general concept of fair market value reflects the agreed-upon cash price in actual transactions between willing and knowledgeable buyers and sellers with opposing economic interests. Simply stated – it is what the purchaser paid and the seller received. Fair market value is the principle that all parties in the debate accept – the issue is how to measure it. The most accurate measure of fair market value will be based on arm's-length prices actually received in the marketplace. All agree, the marketplace for oil and gas is at the lease where the oil and gas is produced.[1] An RIK program can clearly satisfy this objective if independent marketers are responsible for all dispositions of the federal share of production.

Recognizes that arm's-length prices received vary from transaction to transaction. There is no single price for crude oil, natural gas, or indeed for any other commodity, in any given field or area – let alone in a region or nationwide. A number of factors cause prices to vary in local markets and regions across the U.S. No one, for example, expects to always pay the same price for a quart of milk at different locations. True arm's-length prices for a given location and point in time vary depending upon the specific needs of the buyer and the seller. Any accurate valuation system must recognize that the appropriate value will fall within a reasonable range of values. Real estate is a classic example of the importance of location in determining price. The aggregation of volumes can significantly influence the price received. With different lessees controlling differing volumes, we expect price variation to occur. Because an RIK program will be based on market transactions, it will automatically capture the diversity of the marketplace. This, of course, would not be true of MMS' currently proposed oil valuation rule, which assumes a starting point of a uniform "correct" national price for crude oil from a New York futures paper price that would be netted back to the lease through adjustments. There is no national price for milk or real estate and should not be a national price for oil and gas.

Recognizes that value is added after oil and gas is produced at the well on the lease. Various steps and processes are required to deliver crude oil and natural gas to its final destination that add value to the product. Adding value requires investment, results in

[1] MMS several times refers to the determination of value at the lease as being the objective of the proposed oil valuation rule. See, for example, Federal Register: January 24, 1997 (Volume 62, Number 16)], 3747.

costs, and necessitates a market rate of return whether such value is added by the lessee, the lessee's affiliate, or a third party. It is no more appropriate to impose royalties on costs downstream of the lease, including downstream marketing costs, than it is to impose royalties on the costs of operating a gasoline station. Both add value to the product. Neither requires investment by the lessor. Neither is related to the lessor's mineral rights. This value added does not result from the lessor's ownership of the mineral rights, but rather results from the required investment and activities to earn a profit downstream of the lease.

As I said, all agree that the value to be captured is at the lease. From my perspective as an economist, I believe that any approach that attempts to capture royalties on the value added after the lease will operate more like a tax where the tax base varies with the amount of investment associated with marketing. The more investment and effort put into marketing, the greater the tax. As a result, an approach such as was contemplated under the proposed oil valuation rule will distort investment choices to the long run detriment of the nation's economy. An RIK program, at or near the lease could avoid this controversy and the potential marketplace distortions.

Is administrable by MMS and by lessees. A system that cannot be administered will frustrate the intent of all parties. While this statement may appear to be self-evident, it is a warning to not over complicate whatever system the Committee chooses to pursue.

Is perceived by all parties as providing fairness and equity to the Federal Government, state governments, producers, operators, marketers, and refiners. If some parties do not believe they are being treated fairly, the credibility of the system will suffer, compliance will be reduced, investment and production will fall, and the approach will have failed. This, of course, is one reason for today's hearing. Once it is understood how an RIK program will and will not operate, we should be able to make progress in an area where there is now disagreement and controversy.

Avoids economic distortions. Any government-mandated methodology that produces an inappropriate value will distort investment and production decisions. One need only look at the economic damage suffered by the real estate industry during the 1980s. Federal tax incentives first encouraged over-building, and after the boom was well underway, a subsequent and retroactive tax policy change destroyed a great deal of economic value. If the effective royalty rate exceeds the contractual royalty rate through the use of a royalty valuation methodology that overstates market value, less investment and production will result. Initially, this will raise royalty payments, but in the long run, it may reduce royalties and particularly lease bonus payments from government lands.

When making investment decisions, oil and gas producers choose projects that provide the best return, and the royalty rate is a key component in measuring profitability. An RIK program would not create such distortions because the lessee would be delivering the royalty volumes in the percentage stated in the lease contract.

Avoids distributional inequities. As with economic distortions more generally, any system that unduly burdens one segment of the industry more than another will result in not only the perception of unfairness, but also in resource misallocation. If some producers are unfairly burdened through disproportionately high compliance costs or below market returns, their operating costs will increase and the value of their activity will fall. This clearly would have occurred under MMS' oil valuation rule as originally proposed where even tiny purchases of crude oil would have resulted in some operators being no longer eligible for the gross proceeds valuation method and being instead required to use a New York Mercantile Exchange (NYMEX)-based value. In the long run, such distortions could force industry consolidation so that fewer companies will operate on federal lands. While such a policy has not been proposed, if a valuation approach should result in some companies bearing a disproportionate share of the costs, it would affect their market values and investment patterns. Compared with the normal operation of the market today, this would ultimately lead to the sale or transfer of properties at what would otherwise be less than market value, or a reduction in new investment. Other producers who acquire these properties might not be able to operate them as efficiently.

Care must be taken to avoid government-mandated distributional inequities that affect companies according to their specific characteristics, such as their roles in the marketplace. If a royalty system disproportionately harms, for example, refiners or resellers, they will be forced to play a reduced role in the market. Therefore, a royalty system should be designed to prevent the distortion of investment and production decisions based upon company characteristics. To do otherwise will lead to inefficient resource allocation and market distortions to the detriment of all parties. An RIK system that applies equally to all market participants will avoid these potential problems.

Is capable of being applied to changing markets. An inflexible regulatory approach that does not allow for changes in relative market values at the lease of different quantities, qualities, or in different locations will fail to reliably assess fair market values. An RIK program, by reflecting the value placed on production by the market, will immediately respond to market-place changes in a way that regulations designed to establish value never can.

Government revenue considerations

Except on tax issues, the Congressional Budget Office is the congressional agency responsible for estimating budget effects of proposed legislation (the congressional Joint Committee on Taxation handles the scoring of tax issues). My comments on budget scoring effects are my own and should in no way be attributed to CBO. However, they reflect many years of score-keeping experience.

A budget score-keeping estimate measures the difference between a current law baseline and the proposed legislative alternative. Because the Committee is not yet considering a specific legislative proposal, it is impossible to draw firm conclusions about the budget consequences of an as yet unwritten RIK proposal other than to observe that the ultimate design of such a proposal will matter greatly in achieving revenue neutrality. However, an RIK program that meets the criteria outlined above can be designed to at least neutrally, if not favorably, impact the Treasury. The following are a few of the more important design feature that will need to be considered.[2]

Does the proposal change current law? Score-keepers will face the issue of whether proposed legislation actually changes current law. If legislation simply provides additional options to MMS, it is unlikely to be scored. MMS has bare authority to take in kind today. To be scored, any legislation considered by the Committee must require MMS to act differently than it now does.

Will the RIK program be mandatory or voluntary? A program where MMS has sole discretion to determine which volumes to take in kind may under some circumstances generate a revenue gain because the agency could cherry-pick only those volumes that MMS believes will increase government revenues, while excluding from an RIK program those volumes where there might be no gain. As discussed above, however, score-keepers might not acknowledge this result because MMS largely has this authority today. Similarly, lessees delivering in kind only those volumes where they find it most advantageous to do so would be scored as generating a revenue loss. A well-designed, mandatory system avoids both results and would be scored. From an efficiency standpoint, MMS, the states, and industry are unlikely to benefit from significant cost reductions with an optional program.

What is the budgetary impact on the current RIK small refiner set-aside program? In 1995, the most recent year for which MMS has published complete data, on a value-weighted basis MMS took 29 percent of its crude oil in kind (2.4 million barrels or 13.5 percent of onshore value and 19.3 million barrels or 34 percent of value offshore). While we do not yet have complete MMS data for 1996, as illustrated in Figure 1, the RIK program volume and value increased by more than 50 percent over 1995 levels with 33.0 million barrels valued at $566 million taken in kind (2.3 million barrels onshore and 30.7 million barrels offshore). As noted by MMS in the proposed oil valuation rule, the existing RIK program has been criticized for several of its procedures.[3] Depending upon its features, RIK legislation could raise or reduce revenues attributable to the existing RIK program, even though it is already in operation.

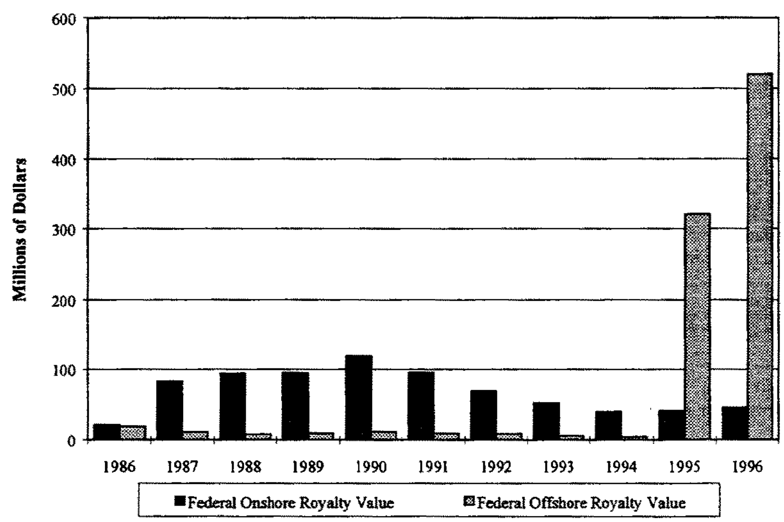
[2] In this discussion, knowledge is assumed of certain basic score-keeping practices and procedures that apply to all proposed legislation. These include the scoring of changes in Treasury cash collections within each federal fiscal year (ending September 30), the distinction between the treatment of some government revenue flows on the receipts side of the budget and other revenue flows, including MMS receipts, as offsets to budgetary spending, and the consideration of budgetary consequences within a specified time period of at least 5 years and typically no more than 10 years. In addition, it is important to recognize in the scoring process that, in general, half of any onshore budgetary consequences will be shared with the states, while all of the Outer Continental Shelf Lands Act budget effects, except for Section 8(g) leases, will be attributable to the Federal Government.

[3] See Federal Register: January 24, 1997 (Volume 62, Number 16)], 3750.

While the reasons are unclear and we must be cautious in interpreting these data without further research, the current onshore RIK program generates a higher net value per barrel for MMS than does the royalty in value program. In each year from 1992 through 1995, the current onshore RIK program resulted in values ranging from a low of 4 percent to a high of 15.6 percent above the average value for all federal onshore oil royalty production. In 1995, for example, MMS received $17.00 per barrel for the onshore RIK program, while the average value per barrel for all onshore federal royalty oil was $14.71 per barrel. One possible explanation for these higher values is that small refiners may be taking in kind crude oil that is, on average, lighter and sweeter than is all onshore federal crude oil. While these data are clearly difficult to interpret without further information and analysis, they contrast with MMS' concerns in the recently published August 1997 RIK study[4] that an onshore oil RIK program may have limited potential as a net revenue raiser. A much more serious analysis of existing data is clearly needed before it is appropriate to draw conclusions.

Figure 1

Royalty Value of Oil Taken In-Kind, 1986-1996



Source: *Mineral Revenues 1995* and preliminary 1996 data from MMS

[4] "1997 Royalty in Kind Feasibility Study," Minerals Management Service Office of Policy and Management Improvement, August 1997.

Does the program create value for the Federal Government? Additional value can be created in a variety of ways. Examples include allowing greater volumes to be aggregated, capturing a share of the value added by moving production downstream, and capturing benefits from increased competition. While score-keepers may not always be able to measure the impact of each specific reason for value creation, the following factors play a role:

- Greater aggregation of volumes can command a higher price in the marketplace. If RIK legislation results in MMS' marketers taking larger volumes in kind than are currently being aggregated by lessees, increased federal revenues should be expected.

- Moving production downstream adds value by reaching additional markets away from the lease. An RIK program provides MMS with an opportunity to capture additional downstream revenues. Where practical, score-keepers will typically look at the experience of other governments, such as under the Alberta and Texas programs, in their assessment of the net impact on government revenues. In addition, experienced marketers are demonstrably able to capture the upper end of the value range through their trading activities. If through an RIK program MMS is able to take advantage of this expertise as production moves downstream, there is a significant opportunity to increase federal revenues.

- Increased competition can, by itself, create additional value. In 1995, the Federal Government could have taken in kind approximately 50 million additional barrels and about 1 trillion cubic feet of gas. Potentially all that production could have been made available as RIK for purchase in an open and competitive market. As more potential purchasers have an opportunity to bid for production, the value of that production would generally be expected to increase to the benefit of the Federal Government. Such an increase should be considered by score-keepers.

How are pipeline transportation costs to be determined? Current law on oil pipeline tariffs is in a state of flux that, absent legislation, is unlikely to be resolved for years. Various regulatory efforts have been underway, and there is certain to be additional litigation over the issue. Industry had until recently utilized FERC tariffs in the OCS. MMS' recent actions and decisions have challenged this treatment. As a result, all I can say at this point is that the revenue impact of this issue is far from clear, and we will not know for certain whether there will be a significant revenue impact until CBO is required to make a determination. Until we reach that point, the Committee should first carefully consider its policy objectives, and then work with CBO to see how they will score the issue. An RIK program could resolve this debate. Thus, it is premature to conclude that charging marketers market rates for pipeline transportation will result in a revenue loss as is suggested in MMS' 1997 RIK feasibility study.

Other related issues

Are the Nation's royalty revenues at risk? This question arose during the Subcommittee's July 31, 1997 hearing, which, in turn, raises two issues: (a) will federal revenues fall under an RIK program, and (b) how will the market for crude oil and natural gas be affected by the government controlling a very large volume of production.

These issues arise, in part, as a result of MMS' pilot RIK program studies. Attachment 2 is an August 4, 1997 Barents Group review of MMS September 1996 report entitled "Minerals Management Service Royalty Gas Marketing Pilot Report." This review addresses the revenue neutrality methodology and conclusions of MMS' 1995 pilot RIK project. Since our report was completed, MMS released on September 2 a new study of the same project "1997 Royalty in Kind Feasibility Study," which addresses some of our concerns, but not others. Thus, our attached review serves as a preliminary indication of some of the issues raised by this most recent MMS analysis.

The Committee can design a program that is revenue neutral, like any other measure, but careful attention must be paid to the details. Because I have no doubt that the Committee is well aware of the need for revenue neutrality in its deliberations, I believe the question is implicitly addressed to the accuracy of any revenue estimates that are provided by the Congressional Budget Office and by the Administration. That is, how well do the score-keepers do their jobs? This same issue, of course, arises with any proposed legislation that must be scored. It might be useful here to briefly explain the estimating process and factors taken into account.

Revenue estimates are designed to measure the difference between a projection of cash collections under current law and under the proposed policy option. In general, the greatest potential for error in estimating federal budget impacts of oil- and gas-related legislation is the result of price forecasting errors. I have been a user of oil and gas price projections for federal score-keeping estimates since the late 1970s. While there have been periods of relative stability and reasonable forecasting accuracy, there have also been times of great price volatility, which can lead to errors in budget estimates that are based on these projections. Fortunately, in most cases, price-related errors in the baseline forecast and in the policy being estimated are the same. As a result, errors in revenue estimates for policy options tend to be either modest or to completely cancel out when compared with projections of current collections. Budget estimates for RIK legislation fall into this category where price-related uncertainty will largely apply equally to both the budget baseline and to the proposed legislation. Certainly other estimating issues will arise, including the proper interpretation of current law. The revenue estimating process is, however, a good one where CBO collects as much information as it can from both MMS and industry and then, after a careful internal review process, develops an objective assessment. If the Congress were to always wait until pending legal controversies and uncertainties were to be resolved, it would rarely be possible to act on legislation. As a result, I don't think we really have much of a problem here.

In response to the second issue, no one has ever suggested that the government get involved in marketing. Rather the issue is whether the government should hire a private sector marketer to give it the opportunity to maximize its revenues for which the marketer would be paid a fee. This would provide the government with the opportunity to participate in the downstream market – a different market from the one that exists at the lease. As a result of the government's implementation of an RIK program, there should be administrative savings, greater efficiency, and a reduction in controversy. Apart from any potential increase in domestic exploration and production activity on federal lands triggered by these benefits, the volume of domestic production will not change. On net, all parties should benefit from a more competitive market.

How can we address properties that may be uneconomic under an RIK program? One issue that may arise with a mandatory RIK program is that due to wells with small volumes or wells in remote locations, it may not always be cost effective for the government to take production in kind. A mechanism adopted under the Royalty Oil and Gas Simplification and Fairness Act of 1996 allows MMS and the states to accept royalty prepayments to reduce administrative costs for MMS, the states, and the lessee, and to encourage continued production from marginal properties. Regulations should be proposed implementing this provision and consideration should be given to expanding it to include the very marginal or remote properties.

While the Act contemplates monitoring and adjusting the prepaid amount to reflect changes in reserves, my view is that to further reduce administrative burdens it is appropriate to give strong consideration to selling outright the royalty stream for these properties. This will allow the efficient monetization of the Nation's royalty stream by completely eliminating the administrative burden for states, the Federal Government, and lessees. The Federal Government and the states will be concerned that they will receive less than fair value for the payment stream, while purchasers may be concerned that they are overpaying, given the potential for mismeasurment of reserves and price uncertainties. If carefully implemented, an expanded and simplified prepayment provision should result in a competitive, market-based, and fair price. The private sector has significant experience with this approach and indeed, operators often pay premiums or bonuses to provide the lessor with a portion of the administrative cost savings. The score-keeping implications of an acceleration or expansion of the prepayment approach when compared with current law are unambiguous – more revenue will be collected within the budget score-keeping period.

The Committee should focus on the net revenue impact of a comprehensive program. It is important to recognize that legislative policy changes have numerous details that require discrete analysis. As a result, it is likely that such proposed changes contain both revenue raisers and revenue losers. Simply noting that one feature or provision results in a revenue loss is not by itself a problem. A budgetary problem occurs only if aggregate losses exceed aggregate gains. This is, of course, a part of the legislative process with all measures and would be no different here. The objective is to design an overall, comprehensive program that meets all of the objectives outlined above.

Administrative cost savings will benefit both the U.S. and the states. In general, one-half the reduction in onshore oil and gas program costs under an RIK program will be shared directly with the states. Thus, states benefit most from an RIK program that minimizes costs by being applied uniformly to all production. An RIK program that applies only to some kinds of production or in some locations will reduce costs to a much lesser extent because MMS will still be required to maintain audit and valuation staff. If MMS should only implement an RIK program in the OCS, the states would generally not benefit from cost reductions.

Some benefits that cannot scored will also be significant. While my testimony focuses on score-keeping effects, there are other economic benefits that are significant even though they may not score. For example, reduced administrative costs will directly benefit the states through higher distributions. A reduction in private sector compliance costs allows the economy to operate with a generally lower and more efficient cost structure. With domestic oil and gas production on federal lands becoming less costly, more federal areas may be developed, which could increase domestic production. The Department of Energy's most recent statistics for July 1997 show domestic production averaging 6.3 million barrels per day, while net imports of crude oil averaged 7.9 million barrels per day, thus any increase in domestic production is important.

Conclusion

In conclusion, a well-designed, mandatory RIK program has significant potential to increase economic efficiency, maintain federal and state revenues, reduce controversy, and be regarded as a fairer approach for the federal and state governments, lessees, and the Nation's taxpayers. Administrative cost savings from such a program will benefit both the federal and state governments. It is possible for the Committee to design an RIK program that applies to all production on federal lands – onshore and offshore, for oil and for gas – that is, in the aggregate, at least revenue neutral. This can be accomplished through careful and thoughtful legislative design within the requirements of the formal budget score-keeping process.

ATTACHMENT 1

AMERICAN ASSOCIATION OF PROFESSIONAL LANDMEN

The American Association of Professional Landmen (AAPL) is a voluntary professional association of approximately 7,200 land professionals working in the oil, gas and mining-related industries. AAPL membership is comprised of landmen working as sole practitioner independents and employees of small, medium, and large independent companies as well as major oil, gas and mining companies. Members of AAPL reside throughout all of the energy producing States.

AMERICAN PETROLEUM INSTITUTE

API is a non-profit, nationwide trade association whose members include over 300 companies involved in all aspects of the petroleum industry: exploration, production, refining, marketing and transportation. Many of API's members operate on federal offshore and onshore lands and their activities account for the vast majority of oil and gas production and royalties paid every year.

COLORADO OIL AND GAS ASSOCIATION

State division of Rocky Mountain Oil and Gas Association.

DOMESTIC PETROLEUM COUNCIL

The Domestic Petroleum Council is a national trade association representing the nation's largest independent oil and gas producers. Collectively, its seventeen member companies produce a significant portion of the oil and gas produced throughout the U.S. from federal lands.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

The Independent Petroleum Association of America (IPAA) is a national trade association representing over 5,000 independents exploring for and producing oil and natural gas in all thirty-three producing states. Independents differ from other segments of the industry as their sole profit source is from sale of oil and natural gas at the wellhead. Independents are very active on Federal lands and account for the nearly 65% of the natural gas and over 40% of the crude oil in the lower forty-eight.

INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES

The Independent Petroleum Association of Mountain States (IPAMS) is a non-partisan, non-profit trade association representing the interests of over 750 independent oil and natural gas producers, royalty owners, consultants, and service/supply companies operating in a ten-state Rocky Mountain area: New Mexico, Wyoming, Colorado, Utah, Montana, North Dakota, South Dakota, Nevada, Nebraska and Arizona. Independent producers are producers whose main source of revenue is at the wellhead and who do not have downstream refining and marketing.

INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO

The Independent Petroleum Association of New Mexico (IPANM), founded in 1978, is a nonprofit trade association. IPANM represents the interests of over 600 independent oil and natural gas producers, royalty owners, and other entities. Members of IPANM principally reside in New Mexico which ranks first in the Nation in terms of oil and gas revenues generated from onshore Federal lands.

MID-CONTINENT OIL AND GAS ASSOCIATION

Mid-Continent Oil & Gas Association, founded in October 1917, is a national trade association representing major and independent oil and gas companies. The Mid-Continent Oil & Gas Association has four divisions: Texas, Louisiana, Oklahoma, and Mississippi-Alabama. The Association's purpose is ". . . the promotion and protection of the oil and gas Industry." The scope of the Association's responsibility is both National/Regional and State/Local.

MONTANA PETROLEUM ASSOCIATION

State division of Rocky Mountain Oil and Gas Association.

NATIONAL OCEAN INDUSTRIES ASSOCIATION

The National Ocean Industries Association (NOIA) is the sole trade group representing the entire spectrum of companies and individuals involved in the exploration and development of domestic offshore natural gas and petroleum resources. Included in this broad-based association membership of over 280 companies are Outer Continental Shelf Operators, both majors and independents, offshore supply and service industries and drilling and diving contractors.

NATURAL GAS SUPPLY ASSOCIATION

The Natural Gas Supply Association (NGSA) is a trade association whose membership is comprised of both major and independent producers of natural gas. NGSA member companies produce and market approximately 90% of this country's natural gas production.

NEW MEXICO OIL AND GAS ASSOCIATION

The New Mexico Oil and Gas Association (NMOGA) represents 300 companies in the State of New Mexico ranging from the very large to the very small. Members such as Exxon to members of two-man offices. NMOGA has been in business since 1927.

NORTH DAKOTA PETROLEUM COUNCIL

State division of Rocky Mountain Oil and Gas Association.

NORTH TEXAS OIL AND GAS ASSOCIATION

OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION

The Oklahoma Independent Petroleum Association (OIPA) is a non-profit association representing more than 1,400 independent crude oil and natural gas producers, operators and affiliated companies. The OIPA's primary focus is advocacy for the Oklahoma independent oil and gas industry in local, state and federal legislative/regulatory venues.

PETROLEUM ASSOCIATION OF WYOMING

State division of Rocky Mountain Oil and Gas Association.

ROCKY MOUNTAIN OIL AND GAS ASSOCIATION

Rocky Mountain Oil and Gas Association (RMOGA) is a trade association with hundreds of members, large and small, who account for over 90% of the oil and gas exploration, development and transportation activities in the Rocky Mountain West.

ROCKY MOUNTAIN OIL AND GAS ASSOCIATION - COLORADO

State division of Rocky Mountain Oil and Gas Association.

TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION

Texas Independent Producers and Royalty Owners Association (TIPRO), founded in 1946, is the largest statewide trade association in the oil and gas industry. It represents large independents, small independents and royalty owners.

UTAH PETROLEUM ASSOCIATION

State division of Rocky Mountain Oil and Gas Association.

WYOMING INDEPENDENT PRODUCERS ASSOCIATION

Wyoming Independent Producers Association (WIPA) is a nonprofit nonpartisan association representing the interest of independent oil and gas producers and service companies that operate in the State of Wyoming. Founded in April of 1990.

ATTACHMENT 2

PRELIMINARY ANALYSIS OF FEDERAL REVENUE EFFECTS OF MMS' ROYALTY GAS MARKETING PILOT PROJECT

August 4, 1997

Introduction

Barents Group LLC, a KPMG Company, was asked by Gardere & Wynne, LLP on behalf of a group of companies having significant crude oil and natural gas production on Federal lands to review a September 1996 report entitled "Minerals Management Service Royalty Gas Marketing Pilot Report." In conducting our study, we were asked to review the report's findings concerning the project's implications for the Federal budget. The report describes a pilot project conducted during 1995 where the Minerals Management Service (MMS) took the Federal royalty share of certain Gulf of Mexico gas leases in-kind rather than in-value.

In analyzing project results, MMS found that while the project was an operational success, it resulted in a net Federal revenue loss of $4.7 million. MMS extrapolated this result into an $82 million loss if the pilot project had been extended to take in kind the entire Federal share of Gulf of Mexico gas production. MMS identified certain project features that contributed to the estimated loss but concluded that even if these were changed, a net loss would still occur.

Our analysis of MMS' report has three major findings.

- <u>MMS' study does not follow Federal budget score-keeping procedures</u>. Budget score-keeping requires a careful year-by-year analysis to formulate revenue estimates over 5- and 10-year time budget score-keeping horizons.[5] MMS' study is characteristic of an "economic impact study" rather than a formal revenue estimate. An economic impact study typically measures long-run economic impacts – sometimes without regard to the year in which the effects actually occur. This is a crucial distinction that leads MMS to find a significant revenue loss, where we would expect to find a much smaller loss or even a net revenue gain if properly scored.

- <u>MMS does not adjust its economic impact estimates to assure that the shortfall it finds in lease revenues result from transactions that are actually comparable</u>. MMS' study provides no assurance that its economic impact estimate actually reflects the difference between lease revenues where royalty is taken in kind and where is it taken in value. Rather, many other unquantified factors could contribute to this gap. For example,

[5] In general, the House of Representatives uses a 5-year budget score-keeping period, while the Senate uses a 10-year period.

MMS should adjust for (a) lower bids that resulted from the accelerated payment schedule required of marketers under the RIK program, (b) costs imposed on marketers of complying with certain record-keeping and reporting requirements for which the marketers expected to be compensated, but that would not be needed in a permanent program, and (c) the marketers' assumption of risk associated with the requirement to take all volumes of royalty gas made available by the operator despite fluctuations in the production level.

- Numerous other project design, data accuracy and validity, and methodological issues contribute to MMS' arriving at an inappropriate assessment of the revenue effect of the pilot program. The combined effect of conceptual problems, errors, and poor data likely leads MMS to significantly overstate the negative economic impact of the pilot program.

In this report, we identify areas requiring further investigation and correction, where such corrections are possible. Where corrections are not possible or practical, these factors may assist in the design of a future RIK program that is structured to allow the Federal revenue impact to be properly measured.

Project Design

Several program features were identified by MMS as contributing to negative revenue effects. Among the factors that MMS identifies as contributing to a revenue shortfall are: (a) inadequate time was allowed for MMS to develop the program and for marketers to prepare bids, (b) additional information is required in the bidding documents, and (c) a future program should be initiated before the winter season.[6] MMS did not attempt to estimate the revenue consequences of these factors.

Potential for self-selection bias. MMS' pilot program is based upon 79 leases volunteered by 14 volunteer lessees. Those lessee's believing they have the most to gain from an expanded RIK program will have a natural tendency to volunteer for such a program, while lessees believing they will more likely be worse off will tend not to volunteer. As a result, revenue losses will more likely occur in a voluntary program than in a mandatory program. Only a mandatory program with a statistically valid sample of leases and lessees should be used for a revenue analysis.

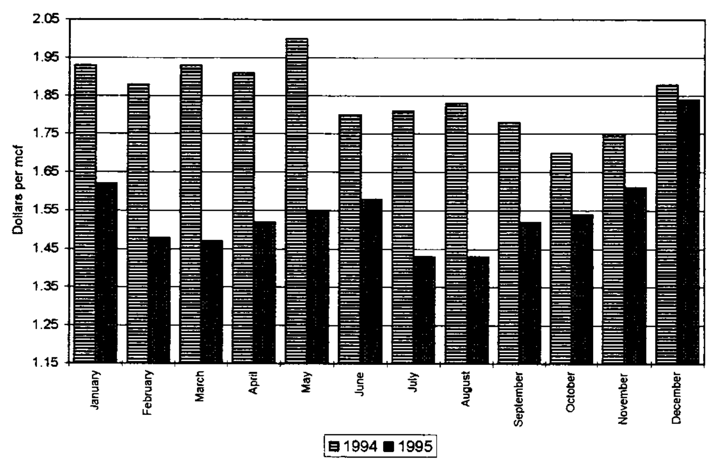
Program duration may have been too short to fairly evaluate the revenue effect of the pilot project. The pilot project lasted for one year – from January through December 1995. As documented in the report, a number of marketers dropped out early because they had different expectations regarding the program's operation and the availability of transportation. As a result, initial start-up costs may have significantly influenced the bidding. In addition, marketers may not have had sufficient time to understand the

[6] Testimony of Cynthia L. Quarterman, Director, Minerals Management Service, U.S. Department of the Interior before the Subcommittee on Energy and Mineral Resources, Resources Committee, June 27, 1996.

characteristics of the lease and the required transportation arrangements, and could warrant deliveries of a lesser portion of the volumes of gas in contractual relationships. The existence of these problems likely reduced bids and Federal revenues. A program of this duration was, however, useful for determining the existence of and solutions to many operational problems.

Period during which pilot was conducted was one of volatile prices and changing market conditions. As shown in Figure 1, U.S. Department of Energy data show much lower natural gas wellhead prices in 1995 than in 1994. On average, wellhead prices were 15 percent lower in 1995 than in 1994, ranging from 24 percent lower in March 1995 to 2 percent lower in December. Institutional relationships may also have continued to change during this period as a result of FERC Order 636.[7] The implementation of a pilot project during this period with buyers being required to establish new marketing relationships very likely affected bid prices and Federal revenues.

Figure 1
COMPARISON OF 1994 AND 1995 NATURAL GAS WELLHEAD PRICES
Reported by the U.S. Department of Energy



Marketers expected to recover through lower bids the cost of post-production value added costs and services that were unique to the pilot program. Marketers undertook pilot program responsibilities for which they expected compensation through bid prices, while lessees are required to undertake similar responsibilities without compensation.

[7] FERC deregulated the natural gas pipeline industry with the issuance of Order 636 in 1992.

Because these costs would be unnecessary under an ongoing RIK program, the lower bids received in the pilot program should not be charged against the revenues that would be received under an ongoing program. While we have not attempted to list all possible value added by marketers for which they expected compensation, these include preparing Form MMS-2014 and providing volumetric and valuation data for the purpose of measuring the revenue effects of the pilot project. While providing data for use on the analysis of a pilot project is desirable, there is no reason for these costs to be experienced in a permanent program.

Purchasers were required to accept 100 percent of the royalty gas made available despite the fluctuation in production levels and to arrange for all transportation. While comparable transportation costs are generally deductible by lessees paying royalties in value, the economic cost of bearing the risk for taking all volumes and arranging for transportation are generally not deductible. Because marketers can and will build these additional costs into their bids, this difference will contribute to MMS' estimated revenue loss. The revenue effects of these features could be mitigated through design changes in future programs – particularly if MMS is willing to accept some risk in exchange for higher revenues.

First-time pilot program costs may have influenced bids and lowered Federal revenues. MMS cites one marketer's estimate "that fees of $0.01 to $0.03 per MMBtu could be expected." MMS also refers to the Texas RIK program where the State pays $0.03 per MMBtu for contract administration expenses. This implies costs ranging between about 0.7 percent to 2 percent of revenues.[8] While numerous adjustments would likely be needed to develop a more accurate comparison, the experience of Alberta with their oil RIK program is that marketing costs equal about 0.2 percent of revenues.[9] This indicates that with more experience a carefully designed and fully operational program may result in marketers bidding significantly lower margins, an increase in Federal collections, and a significant reduction in MMS' estimated revenue loss.

An accelerated schedule may have resulted in marketers rather than MMS benefiting from the gain on natural gas liquids. A "partially avoidable factor" cited by MMS as contributing to the revenue loss was that sufficient Btu information was not made available to marketers so that they could take into account the enhanced value of natural gas liquids. As a result, they may have bid lower values than warranted. This will artificially increase the estimated revenue loss. By using Btu content data now available, MMS should be able to adjust the results of the study to reflect the opportunity to realize additional Federal revenues from NGL sales.

[8] Because margins were not separately stated in bids, MMS reports only the range provided by one potential bidder. Using information in the report and national aggregate relationships reported by the Department of Energy, we adjust for the relationship between heat content and volumes to estimate the 0.7-percent to 2-percent range in margins as a percentage of total revenues.

[9] This figure is based upon Alberta's experience over the June 1996 through May 1997 period.

MMS and the Office of Inspector General identify numerous other "lessons learned," many of which would result in increased net Federal revenues under an improved RIK program. Potential improvements the Office of Inspector General identifies include the following:[10]

- "Future pilots should encompass a (broader range) of producing companies, lease types, and lease ownership situations;"
- "The MMS should offer bid packages with larger volumes of gas and warrant volumes;"
- "The MMS should package lease groups along logical transportation routes;"
- "The MMS should attempt to negotiate reasonable transportation fees for non-jurisdictional pipelines;"
- "The MMS should include more information in the IFB [Invitation for Bids] and spend more time validating it; and;"
- "The MMS should explore the concept of taking royalty gas in kind and using it in federal facilities."

While there is not uniform agreement on the OIG's findings, they are appropriate for additional consideration. The OIG's comments on larger production volumes are especially important. It is well recognized that the relatively small volumes spread over a wide geographic area resulted in little opportunity to enhance revenues through the aggregation of volumes. Implementation of the OIG's findings could increase Federal revenues under a restructured RIK program.

Accuracy and Validity of Data

The accuracy of MMS' analysis was impaired by the lack of accurate data. Citing a number of data deficiencies, MMS employed several methods for assessing the accuracy of its estimating methodology. In each instance, MMS appropriately identified its concerns, but the lack of accurate data is unfortunate and calls into question the validity of MMS' conclusions. Following are examples cited by MMS:

- "We eliminated the top and bottom 2 percent of the leases based on our calculated MMBtu values assuming that the data was unreliable."[11]

[10] Pages 24-25. All page numbers refer to "Minerals Management Service Royalty Gas Marketing Pilot Report," September 1996.
[11] Page 5.

- "This method was not selected to be the primary method because 1) it relies on a very small number of leases to make a projection, 2) errors to reported data (such as Btu content information) could result in skewed results ..."[12]

- "The Auditors identified significant errors in the data contained in many reports, concluding that the reports were inconsistent and unreliable for both royalty valuation and pilot revenue impact analysis purposes."[13]

MMS appropriately qualifies its analysis by noting data limitations, yet it is impossible to tell from the report whether the conclusions drawn can be supported. MMS is to be commended for testing alternative analytical approaches. Indeed, MMS draws comfort from finding that all the methods it tested indicated a revenue loss would occur. Because much of the data collected are suspect, however, the reader has no way to determine whether MMS' findings are valid.

Methodological Problems

MMS' estimating methodology is not robust. MMS tested its estimating methodology using several procedures. Each procedure produced generally similar losses ranging from $4 million to $5.1 million for the pilot project. MMS' best estimate was $4.7 million.

MMS' preferred method is to compare the revenue received per MMBtu from the pilot leases in 1995 with the revenue received from the same leases in 1994. The 1994 revenue per MMBtu is adjusted to reflect the percentage change in prices on similar leases not included in the pilot program. This approach raises numerous questions concerning the true comparability of the leases chosen. Indeed using the January 1995 example reported in the study, MMS shows revenue per MMBtu declining by 22.6 percent from January 1994 to January 1995,[14] while as previously illustrated in Figure 1 national average wellhead prices reported by the Department of Energy dropped by 16.1 percent. This difference may be completely explainable, but the lack of documentation is troubling.

The methodology we would find most compelling would be one that carefully identifies transactions from leases where royalties are paid in value during the same time period and from approximately the same location and that are in most respects comparable to the RIK leases. Adjustments are required for all factors influencing price, such as the reliance on non-jurisdictional pipelines, the distance from marketing centers, differences in available volumes, and differences in payment terms. MMS did not undertake such an analysis. Comparable leases could include those from which the royalty was actually taken in kind. Here, an assessment of the value per MMBtu received by the operator could be compared with the value per MMBtu received by the marketer to determine whether the prices differed and then to study those factors that contributed to this difference. MMS

[12] Page 8.
[13] Page 8.
[14] Page 6.

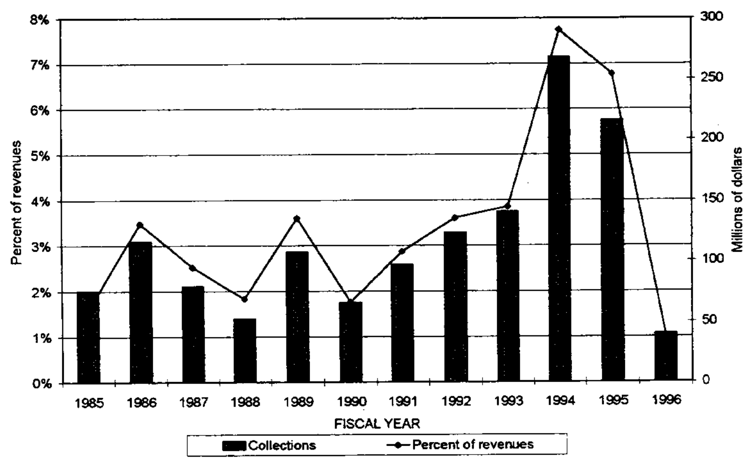
attempted to make this comparison, but could not perform a complete analysis due to data deficiencies. MMS' says its partial analysis of these data indicate a revenue loss; however, given the data limitations, this finding has uncertain validity.

MMS inappropriately adjusted its baseline revenues to reflect a 3 percent increase from future audits. MMS increased its estimate of revenue collected under the existing royalty in value program by 3 percent to account for future audit and enforcement collections that would be unnecessary under an RIK program. Regardless of the accuracy of the 3-percent estimate, this figure includes adjustments for both volumes and prices.[15] Because the pilot RIK program is equally subject to volume-related audit adjustments, only that portion of the historical audit relationship should be assumed. We do not know the relative mix of price- and volume-related audit adjustments and thus do not know the significance of our proposed adjustment. It important to recognize, however, that MMS' 3-percent adjustment by itself accounts for almost half of the estimated revenue shortfall ($2.2 million of the $4.7 million total). This adjustment is particularly troubling in that a surge in audit collections during FY 1994, by itself, causes the 10-year average MMS uses to establish its adjustment to increase by 0.5 percent. Indeed, FY 1995 audit collections which are not included in the audit rate calculation dropped by 19.5 percent and more recently available data for FY 1996 show audit collections dropped by an additional 81.6 percent. As shown in Figure 2, MMS reports that audit collections equaled only $40 million (1.0 percent of revenues) in FY 1996, in contrast to the $268 million collected during FY 1994.

[15] MMS' figure is based upon adjustments for oil, gas, and other minerals from offshore, onshore, and Indian leases.

Figure 2

TOTAL MMS AUDIT COLLECTIONS
(Includes all lease types for all minerals)



MMS extrapolates its estimated revenue loss to a Gulf of Mexico total without any documentation on its methodology. MMS concludes that the RIK pilot project, if it were to be extended to all Gulf of Mexico gas leases would result in an annual revenue loss of $82 million. Because no documentation is provided on how this computation was performed, we have no way to assess its accuracy. Clearly any computation must assure that pilot project results are appropriately weighted when developing Gulf-wide estimates. For example, it would be inappropriate to simply scale up the estimated revenue loss on the pilot project by the ratio of either gross revenues or the volume of gas production in the Gulf to the revenues or gas volumes in the pilot project. Adjustments would be required for differences in the attributes of pilot project leases in comparison with those of other Gulf leases. For example, if the pilot leases were to be more heavily skewed to areas closer to land than is Gulf of Mexico production in general, or if the sample required greater or lesser use of nonjurisdictional pipelines, it would be appropriate to take these factors into account when estimating totals. MMS provides no indication of whether or how it addressed these issues.

MMS inappropriately concludes that marketing costs and non-jurisdictional pipeline tariffs are unavoidable sources of the revenue loss. Regarding marketing costs, MMS says, "We view these marketing fees as barriers to revenue neutrality under any similarly-structured program since the lessee must bear all costs of marketing without cost to the federal lessor when royalties are paid in value."[16] MMS believes that rates charged for transportation on non-jurisdictional pipelines "were considerably higher than actual cost basis allowed under current regulations."[17] While the interpretation of the duty to market is a legal and contractual issue that we cannot address here, there are numerous program design issues that could mitigate, if not eliminate, any properly estimated Federal revenue loss.

MMS does not recognize that additional Federal revenues will be realized through increased future lease bonus payments as a result of reduced administrative burdens and increased certainty. Potential lessors will value the burden reduction that would result from the successful implementation of an RIK program. Future lessees will benefit from the significant reduction in uncertainty with respect to valuation adjustments. MMS recently reported $812 million of high bids for a Gulf of Mexico sale[18] indicating that relatively small increases in bid prices can have large Federal revenue consequences. Any resulting increase in lease bonus payments would immediately increase Federal revenues within the budget score-keeping period.

MMS does not follow Congressional Budget Act score-keeping requirements. Congressional score-keeping rules require an analysis of the budgetary impact of a policy change for each fiscal year expressed in the dollars of that year. While it is not possible to estimate the revenue effect of any proposed policy change without detailed conceptual or statutory language, one major factor MMS has not recognized in its analysis is the acceleration of revenues that would result from valuation-related audits no longer being required.

Under the existing program, the collection of audit revenues is deferred for many years due to lags between the time of production and when audits commence, and the time from when any deficiency is asserted to when the Government actually receives payment. While the Government may be kept whole on a time-value-of-money basis through the collection of interest on underpayments, this analysis is not correct for congressional score-keeping purposes.

If the Federal Government receives all its revenues under an RIK program in the month following the month of production rather than 6 or more years after the fact, the gross revenue from these audit collections will be brought into the 5- and 10-year budget score-keeping periods. Assuming MMS' 3-percent audit adjustment factor is correct, this will result in a substantial acceleration of revenues.

---

[16] Page 11.
[17] Page 11.
[18] "Central Gulf of Mexico Sale 166 Nets $812 Million in High Bids," MMS New Release, July 18, 1997.

MMS reports preliminary calendar year 1996 offshore gas royalty collections of $1934.9 million.[19] For each year of acceleration brought into the budget score-keeping period, the Federal Government will receive an additional $58 million. Because a number of years worth of audit collections could easily be accelerated under such a program, the budget savings will be quite substantial. If there were, for example, an average lag in audit collections equal to 5 years and no adjustment is made for any changes in gas prices or production volumes, an audit-related revenue gain of $290 million would occur within the budget score-keeping period. By making the appropriate adjustments to the program and the revenue estimating methodology, even more revenue should be scored within the budget period.

Conclusion

MMS has performed a valuable study that identifies many opportunities for developing a well-designed RIK program. While the study provides useful guidance on the economic effects of such a program, additional documentation, data validation and correction, and analysis is required. Once this work has been completed and proper congressional score-keeping procedures are observed, we believe that it is likely that a permanent RIK program can be implemented, which can be scored as raising net federal revenues.

[19] This includes $1,865.7 million of gas royalties and $69.1 million of gas plant royalties. Largely due to recent price increases, gas royalties have contined to increase rapidly. Indeed, recent statistics for the first quarter of 1997 show Federal offshore gas royalties increasing by 63 percent over the same period in 1996 – from $387.9 million to $632.3 million. See "Mineral Revenue Collections, January - March 1997," Minerals Management Service, p. 10.

STATEMENT OF TIMOTHY COHELAN, ATTORNEY AT LAW, REGARDING STRUCTURE, MECHANICS, AND ECONOMICS OF THE CRUDE OIL INDUSTRY IN CALIFORNIA RELATIVE TO PROPOSED R-I-K PROGRAM BEFORE THE SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES COMMITTEE ON RESOURCES UNITED STATES HOUSE OF REPRESENTATIVES SEPTEMBER 18, 1997

Madam Chairman and Members of the Subcommittee:

Thank you for inviting me to present testimony concerning the structure, mechanics and economics of the oil and gas industry as it relates to the concept of using an R-I-K program versus federal royalty "in value."

I draw almost entirely from my experience in connection with a pending California state court civil action. Aguilar, et al v. ARCO, et al. (San Diego Superior Court) is a certified class action in which 22 million California consumers are represented by our office in connection with allegations of price fixing which, of course, the industry strongly denies. Among other things, it is our belief that the normal market structure of oligopoly has moved from non-collusive to collusive in connection with the implementation of certain California regulations for re-formulated gasoline instituted in March, 1996.

California Crude Oil Markets - A Concentration of Sellers

California crude oil or San Joaquin Valley crude/Kern crude provides approximately 1 million barrels of crude oil that is then primarily sold to California's refiners. Over 50% of the crude oil used in California is Alaskan North Slope with the difference largely being comprised of California based heavy crude oils.

The competitive characteristics of the market are rapidly changing. California upstream markets have recently begun to concentrate. A pending Shell/Mobil merger of crude oil fields when matched with the Texaco/Monterey Resources merger, will result in approximately 60% of the daily production of California crude being controlled by three entities. Texaco currently produces 126,000 barrels of oil a day in California and recently announced plans to acquire Monterey Resources which has approximately a 54,000 barrel a day production in Kern Fields. Shell and Mobil also recently announced plans to combine oil fields in California. In 1995 Shell's California operations produced 140,000 barrels of crude oil daily, second only to Chevron's 152,700 barrels. Mobil produced 105,000 barrels of crude daily in 1995. Approximately 1 million barrels of oil are totally produced in California every day.

This crude oil reaches the refining centers in the Bay area and in Los Angeles largely through proprietary pipelines. Heavy crude is heated for transportation or blended with light crude while it is placed in a crude oil pipeline. Apparently heavy crudes, however, are usually heated to allow for the refinery configurations which allow for refining of heavier crude oils. These pipeline systems are owned by three majors, Chevron, Mobil, and Texaco which is the biggest.

This crude oil reaches California's refineries which utilizing proprietary pipelines owned and controlled by majors. Competitive economic considerations may, and often do, come into play in connection with the transportation to "market."

Although 25% of federal lands located in California are San Joaquin Valley heavy crude, the offshore federal production would also be affected by this increasing market concentration.

California Refinery Mergers and CARB GAS - A Concentration of Crude Buyers

The consolidation of California's downstream crude oil customers - the refiners - also has significant implications for an R-I-K program.

The California Energy Commission has stated California's refining sector trends show cause for concern. Fewer refineries are now located in California. CEC labels a "major challenge" facing the oil industry over the next decade "the availability of refining capacity to make fuel to California's specifications, especially reformulated gasoline and diesel." (See California Fuels Report, California Energy Commission, 1995.) Since 1982 the number of operating refineries has decreased from 44 to 24. Today California's CARB Phase 2 reformulated gasoline, however, is only made by 12 refineries all presently owned by majors.

California's motor gasoline markets have become extremely concentrated with recent merger activity, both actual and proposed. If a pending Texaco/Shell merger is accomplished, almost 80% of California's gasoline will be refined by four separate entities, Chevron, ARCO, Shell/Texaco and Tosco/Unocal.

Tosco/Unocal, after its merger, now operates four California refineries and sells gasoline through over 2,000 stations under the names of British Petroleum, Circle K, Unocal and Unocal/76. The completion of this recent merger has allowed the consolidation of production and pricing decisions throughout California. The additional remaining major market players, Mobil, Exxon and Ultramar/Petro-Diamond, provide the market dynamics. They can be expected to make production and supply decisions that ensure a predictable and stable demand for crude oil.

Since there will be fewer buyers in the market place for California crude oil due to this concentration, there will be increasing pressure on crude oil prices and a substantial motivation from this increasingly small group to acquire crude oil, whether from the Alaska North Slope, the Persian Gulf, or from the San Joaquin Valley fields, at the lowest possible price. Also given the constraints of the crude oil marketing mechanisms, it is unlikely that a manageable and practical R-I-K marketing system could be achieved in California.

My involvement and concern has to do to with the increasing pressure on California retail prices which we believe is a direct result of industry concentration and collusive production, supply and pricing practices. Industry concentration in California will increasingly allow for wider refining margins which will increasingly cost California drivers at the gas pump. Following their economic interest in increasing this profitability, this new concentrated California refiner buyers' market will also attempt to depress to the maximum extent possible, its actual operating costs including the cost of crude.

Implications for R-I-K in California Crude Oil Markets

Natural gas markets use "market centers" to allow for a maximum exposure to numerous buyers and numerous sellers to the market place. To the extent that the maximum number of market players is interacting, both buyers and sellers in the face of other market forces such as demand and product availability, the likelihood is that fair market values are assigned.

The California experience indicates that the industry is in a period of substantial transition. Domestic crude oil markets appear to be undergoing concentrations as California evidences. This has the affect of placing fewer sellers into a market structure in which the government would be seeking to compete. In California, based upon our review, it makes no sense whatsoever.

The downstream consolidation that California and much of the United States is undergoing also has substantial implications for any government R-I-K program. Domestic refining markets are undergoing "rationalization" and the overall crude throughput capacity more closely matches the domestic markets demand. This indicates a decreasing number of domestic buyers for crude oil products if the government is in the business of selling.

In our case it has become clear that there is market power that is being exerted by the limited number of California oil companies that refine and market gasoline. Market power, of course, is the power to change a market price by adjusting the amount that's produced. This occurs daily in California in connection with CARB gas.

Substantial barriers to entry exist which also facilitates the collusive nature of the California refining industry. Obviously, initiating or starting a refinery in California would be difficult or impossible today. Also the numerous small refiners that formerly provided the extra margin of competition have gone out of business or have turned to production of asphalt or other non-motor gasoline products because of an inability to provide the improvements necessary to convert to CARB Phase II gasoline.

A study of empirical work considering interaction among firms supports intuitive ideas about whether tacit or explicit collusion can persist in an industry. The familiarity that firms have with each other in terms of production cost plays a critical role. Each refiner in California, of course, knows all of the important competitive production prices of its competitors. Collusion thrives also where market demand is stable. California motorists consume something in the order of 920,000 barrels of gasoline per day with a predictable fluctuation between seasons. Each of California's major gasoline marketers also monitors the prices of each of the other firms, including its wholesale prices at the rack/terminal and dealer tank wagon level. Ability to monitor output can also be a factor given the interaction between trading departments and the availability now of aggregated production records by the California Energy Commission which is now made available to each refinery. It has always been the case that when fewer firms are in a market, the more it is more likely for collusion to occur and California is now moving from nine companies to seven with two recent mergers, Unocal/Tosco and Shell/Texaco (merger pending). Seven market makers are not enough to prevent collusive pricing and coordinated production decisions, given the incestuous nature of supply relationships. The products that all of these companies make are now standardized and therefore these rival products are subject to common specifications such as those of the California Air Resources Board and the Santa Fe Pipeline system. Given this great degree of interchangeability at present, California's oil refiners share among themselves important supply relationships, both on a term sale, geographic exchange and spot sale basis, that ensure that everyone's production capabilities will match their market share.

These upstream and downstream trends in the California Crude oil markets have critical implications for the federal government in connection with its present review of whether an R-I-K structure would work anywhere for crude oil. The question, however, for the government is whether or not these market risks will yield benefits to the government in light of these uncertainties.

Whether or not crude oil or natural gas is involved, relevant R-I-K questions are:

1. What is the nature of the local market place in which the government will be competing?

2. What is the logical geographical definition of the downstream market for my product? For instance, is it domestic refiners serving a defined and predictable geographic area?

3. What total market concentration trends occur at the upstream or downstream levels? Are there fewer sellers in the market in which the government will be competing? Are there fewer buyers in the market in which the government will compete?

4. How are prices set? Will there be independent objective bench mark pricing or will prices be conducted based upon ambiguous market interactions, such as "small spot sales" which guide overall pricing levels?

COHELAN & KHOURY

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

ATTORNEYS AT LAW

701 "C" STREET
SAN DIEGO, CALIFORNIA 92101-5307

TIMOTHY D. COHELAN,* APLC
ISAM C. KHOURY, APC
DIANA M. KHOURY
J. MARK McNEILL
MARGARET L. COATES

(*Also admitted in the District of Columbia)

TELEPHONE (619) 595-3001
FACSIMILE (619) 595-3000
VOICEMAIL (619) 645-8167

September 15, 1997

VIA FEDERAL EXPRESS

The Honorable Barbara Cubin,
Chairman, Subcommittee on Energy and Mineral Resources
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON RESOURCES
1626 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Cubin:

Thank you for the opportunity to address the commission concerning proposed R-I-K legislation.

This office presently represents approximately 22 million California consumers in a pending class action in the San Diego Superior Court which alleges that nine major oil companies have engaged in price fixing activity in connection with the introduction of the CARB Phase II gasoline in California in March, 1996. Trial commences in November of this year. It is our belief that California consumers have been substantially overcharged at the retail pump, largely because of substantial wholesale price, production and supply coordination by the nine major oil companies who are defendants in the case.

In my statement prepared for presentation to the Committee, we basically emphasize the increasing down stream market concentration in California, a major market for gasoline and also concurrent upstream San Joaquin Valley crude producer market concentrations. My analysis of the structure, mechanics and economics of the crude oil markets in California as it relates to the concept of an R-I-K program versus federal royalty taken in value is attached.

Again, thank you for the opportunity to present our opinions.

Very truly yours,

Timothy D. Cohelan

TC:nhg
Enclosures

Cohelan on

California Class Actions

by

Timothy D. Cohelan

WEST GROUP

ABOUT THE AUTHOR

Timothy D. Cohelan is the founding partner of Cohelan & Khoury, a civil litigation firm specializing in class actions and located in its own building in San Diego. Cohelan and the firm have been counsel or co-counsel in civil matters that have recovered for plaintiffs over $225 million in verdicts, judgments, or settlements since September 1993.

Cohelan & Khoury have successfully prosecuted class actions cases on behalf of urban homeless entitled to emergency shelter; victims of a national health insurance fraud scheme; retirees entitled to pension benefits; defrauded investors; victims of discrimination; and workers entitled to back wages. Cohelan & Khoury are AV-rated by Martindale-Hubbell.

Cohelan served as Chairman of San Diego Regional Coastal Commission from 1978 to 1981 and regularly serves as judge pro tem of the municipal court and has co-chaired the San Diego County Bar Association Subcommittee on the Homeless. He is a 1974 graduate of California Western School of Law, where he served as an editor of Law Review. He served as an officer in the U.S. Navy from 1968 to 1971 and received a B.A. from the University of Arizona in 1967. His previous education was received from the public schools of Washington, D.C.; Leeds, England; and Berkeley, California. He is married with one child and resides in San Diego.

TESTIMONY BEFORE THE COMMITTEE ON RESOURCES

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

Thursday, September 18, 1997

Washington, D.C.

Royalty-In-Kind

Bob Neufeld

Vice President, Environment and Governmental Relations

Wyoming Refining Company

Chairman Cubin and members of the Subcommittee:

My name is Bob Neufeld. I am the Vice President of Environment and Governmental Relations for Wyoming Refining Company. My responsibilities include primary management of Wyoming Refining Company's current dispute with the United States Department of Interior's Minerals Management Service. Wyoming Refining Company understands the Subcommittee is studying whether and how to alleviate the disruption, uncertainty and inequities caused by after-the-fact changes to federal oil values.

We also understand the Subcommittee is considering a royalty-in-kind program in which the United States would take their oil royalty in-kind and market it to realize income from federal leases. This would break the dependence on historical reconstruction and on non-market and wastefully expensive adjudication for setting royalty values. Rather, it will require the federal government to use its own arm's length transactions, the primary standard for setting value under today's system, as the irrefutable and final measure of federal oil values. An RIK oil program, correctly run, will be a significant improvement over the present policy of second guessing.

My testimony today is intended to shed light on how not to run a royalty-in-kind (RIK) program. The federal government has been running a small scale RIK since 1946. My testimony will describe Wyoming Refining Company, its historical involvement in the RIK program, how Wyoming Refining Company has been brought to the brink of bankruptcy through MMS' interpretation of current rules and our support for a solution to this burgeoning quandary.

Wyoming Refining Company is a small refiner whose only significant asset is a 12,500 barrel per day refinery located in Newcastle, Wyoming. We are the largest private employer in Weston County and are one of four refineries still operating in Wyoming. In 1980, there were 14 operating refineries in the state. Wyoming Refining Company is not vertically integrated. We own neither oil wells nor downstream retail operations. We purchase crude from various suppliers which until this year included the federal government, and we sell refined products to wholesale purchasers. Our profit comes from the margin between the cost of crude oil and the sales price of our products.

Wyoming Refining Company's largest customer is Ellsworth Air Force Base in Rapid City, South Dakota. Since the 1960's, we have supplied approximately 90% of Ellsworth's jet fuel requirements. In addition, we produce about 50% of the motor fuel supply for the Black Hills region of eastern Wyoming and western South Dakota. Wyoming Refining Company is an important economic asset for a relatively isolated region. The company's demise would mean both the loss of jobs and higher fuel prices in an area short on refining capacity and would have implications for our national defense as well.

The small refiner RIK program has been an important source of crude oil for Wyoming Refining Company for almost twenty years. In fact, during the last ten years ending in 1997, when we were forced out of the program by MMS, crude oil purchases from the small refiner RIK program amounted to more than 40% of our total crude consumption.

The program was authorized by Congress in 1946 as an amendment to the Mineral Leasing Act of 1920. Its goals, to encourage oil company competition and to enhance the availability and stability of American defense fuel supplies, were promoted by selling some federal crude to small refiners thereby denying large vertically integrated oil companies exclusive access to federal oil. When the Secretary of the Interior determines that adequate supplies of crude oil are not available to small refiners at reasonable prices, MMS elects to take the federal oil royalty from some leases in kind rather than in cash and sells it to qualifying small refiners. In almost all cases, RIK oil we purchased was produced by large vertically integrated oil companies and would not have been available to us without the small refiner program. In these cases, the United States realizes the same oil revenue through sales to small refiners rather than through cash payments from producers.

Until the current controversy began, MMS has always invoiced Wyoming Refining Company based on oil values reported to MMS by the producer. We have always paid the invoices in full and on time. On occasion, Wyoming Refining Company has found the oil to be priced too high for its purposes, and we have exercised our right to cancel further oil deliveries.

In spite of the fact that the small refiner RIK program has worked successfully and as intended for decades, current events lead us to conclude that MMS is destroying the program. Our story is important to the Subcommittee because it illustrates the absolute absurdity of changing oil values in after-the-fact adjudications.

On May 23, 1995, MMS sent Wyoming Refining Company a demand letter ordering us to pay an additional $1,468,431 for RIK oil delivered from one large oil company's federal leases during the period of May 1, 1987 through September 30, 1992. In addition, Wyoming Refining Company was ordered to pay $969,569 in interest charges accruing from the date these additional amounts are alleged to have been due. Apparently, the states of Montana and North Dakota, under a delegation of authority from MMS and after auditing this producer's production and valuation in those two states, determined that the producer had undervalued the oil sold to us. As MMS would not claim responsibility for overseeing the producer's valuation, MMS turned to us and imposed a retroactive price increase plus interest on oil sold and delivered to Wyoming Refining Company as many as eight years earlier! We immediately canceled any further deliveries as uneconomic.

In addition, MMS has informed us that other leases produced by two large oil companies in another state and from which we also have purchased RIK oil are being audited and that we can expect further retroactive increases in these cases approaching $4.5 million. Simultaneously, MMS adjusted current deliveries from these leases, and Wyoming Refining Company again exercised its option to cancel future deliveries as uneconomic. Now, Wyoming Refining Company no longer participates in the small refiner program having been chased out by the producers' alleged valuation errors and MMS' policy of making small refiners pay for those mistakes. The company is now in financial jeopardy due to MMS' allegation of their right to retroactively increase prices by more than $7 million over the last eight years. Please bear in mind that Wyoming Refining Company is not a large enterprise but a small business with stockholders' book equity not much larger than these demands.

Under present rules, in order to appeal any MMS demand letter to the MMS Director, any RIK refiner must post a bond or letter of credit equal to the amount demanded. Thus, in Wyoming Refining Company's case our banks so far have had to provide a $2.4 million letter of credit. When the next demand letter arrives, Wyoming Refining Company will have had to post letters of credit exceeding $7 million. Unsurprisingly, our banks have already told us that if another MMS demand letter were to issue, we will be taken involuntarily into bankruptcy.

Although Wyoming Refining Company disagrees with the higher value imputed to already purchased oil and, therefore, has not benefitted from the producer's valuation, even more disturbing is the government's callous disregard for commonly accepted and necessary business principles. For example, by waiting eight years after delivery, MMS has denied Wyoming Refining Company its contractual right to cancel deliveries of that RIK oil. Most irritating is the fact that MMS knew as early as 1989 that the producer's values were suspect but failed to notify us of this knowledge. Instead, MMS continued to parrot in our invoices the producer's reported but suspect values thereby inducing continued acceptance rather than cancellation of future deliveries.

Having seen the damage current policy is inflicting on small refiners and the small refiner program, MMS now wants to change that policy. On January 24, 1997 MMS proposed changes to 30 CFR part 208 which includes language stating "MMS will calculate and provide that [royalty oil] value to the buyer". MMS held a series of hearings on its proposed changes. On April 15, 1997, Wyoming Refining Company along with several other small refiners attended the hearing in Lakewood, Colorado. I directly asked Deborah Gibbs Tschudy, Chief of the MMS' Royalty Valuation Division, whether the intent of this proposed change was to ensure that oil values would not be changed once the small refiner had paid the MMS invoice. Ms. Tschudy replied that this understanding of the proposed rule was correct and that the adoption of the part 208 changes would mean no retroactive price increases. Madam Chairman, we strongly support MMS' adopting the new rules making it difficult to continue a policy that is destroying all RIK small refiners in general and Wyoming Refining Company in particular.

Meanwhile, as MMS has been giving due consideration to its proposed part 208 changes, Wyoming Refining Company has been forced to spend hundreds of thousands of dollars defending the producer's reported oil values and itself from accusations that it benefitted from the producer's alleged mistakes. If Wyoming Refining Company is correct on the law, then our entire ordeal was unnecessary, and no small refiner should have to endure such expense of time and money. If MMS is correct on the law, the law needs to be changed by the executive branch in the current process or, failing that, by the legislative branch.

Our observations gleaned from our two and one-half year ordeal are as follows:

1. **MMS needs to decide whether it is selling oil or collecting royalties.** MMS seems to believe that Wyoming Refining Company owes royalties to the United States. The word "royalty", however, does not appear in our RIK purchase contract. We never signed a lease with the federal government, we never produced any oil and we never reported on any oil values for production from federal leases. We simply took delivery of oil at the unit sales point and paid the MMS invoices at prices dictated to us by MMS. The lease and the valuation reports were all controlled by the producer who had the royalty obligation, and the prices were then repeated to us by MMS in the RIK invoices. MMS clearly is attempting both to sell oil to small refiners and to collect royalties from them at the same time. We believe it is not possible to do both. Certainty in oil marketing transactions cannot exist when the federal government itself does not distinguish between a fundamental business mission, i.e. - generating income from natural resource development, and a regulatory function, i.e. - the tax-like act of collecting royalties. To improve the present situation for all oil production, the United States must decide whether they are in the tax business or the oil and gas business. Ultimately, prices and sales should be final, and we hope the Subcommittee can find a way to accomplish this.

2. **MMS' behavior has prevented Wyoming Refining Company from exercising its contractual right to cancel deliveries.** All parties agree that our RIK contract contains the right to cancel deliveries. Because of the timing sequence in the contract, however, the small refiner receives the RIK invoice 45 days after the RIK oil delivery and must always pay for oil already delivered even if the price is uneconomical. However, once the price of delivered oil is known to the small refiner, future deliveries of uneconomical oil can be canceled. As noted above, Wyoming Refining Company has exercised the cancellation option several times never suspecting that MMS would circumvent this contractual right in the future. Nevertheless, by waiting until all oil is delivered before revealing the "true" price, MMS has, in fact, done just that. In claiming it can hide the final price of the oil for years after delivery, MMS is arguing that the small refiner must accept and pay for all oil no matter how uneconomical and that the right to cancel future deliveries is totally illusory. MMS has elevated the rather pedestrian practice of bait and switch to the high art of deliver and re-price.

3. **MMS could have prevented this crisis and did not.** The audit period of our case covers RIK oil sold to Wyoming Refining Company between May 1, 1987 and September 30, 1992. As early as 1989 or perhaps even earlier, MMS suspected that it disagreed with its prices in our invoices. MMS did not tell us of this suspicion or give any other indication that it had superior knowledge regarding the price of RIK oil delivered to us. Rather, MMS continued to deliver RIK oil to Wyoming Refining Company, billing us at prices reported by the producer and thought by MMS to be incorrect. In other words, MMS

manipulated the small refiner RIK program so that we were unknowingly allowed to increase our exposure and risk of bankruptcy. We know this because MMS sent a demand letter to the producer regarding leases producing our RIK oil in March of 1990. An informal payment request was sent earlier the same year. The producer audit was undoubtedly heading for a conclusion of under valuation significantly before that. However, it was not until 1994 or 1995, significantly after the audit period, that Wyoming Refining Company had any notice of the producer audit or any other indication that the prices in our invoices were under review. Innocently, we continued to purchase the disputed oil during the audit period and beyond until MMS belatedly told us prices were being changed retroactively. Wyoming Refining Company then canceled further deliveries of RIK oil from these leases. Our exposure had been unnecessarily and irreversibly increased while MMS stood silently by and allowed it to happen.

4. **MMS' interpretation of the regulations allows an under reporter to escape while an innocent purchaser's evidence is ignored.** In order to defend itself and to appeal this case to the MMS Director, Wyoming Refining Company was forced to gather a significant amount of evidence regarding the value of its RIK oil purchases. Unfortunately, we have received no assistance at all from the producer in this regard. This evidence has cost us over $250,000 to produce. An MMS Associate Director, however, has denied our appeal. One would think MMS would at least provide a rational explanation as to why it chose one body of evidence over another. Conveniently, the Associate Director has sidestepped the issue holding that the royalty value determined in the producer's audit, an entirely separate case, "is applicable to the Appellant's RIK purchases and is controlling with respect to the subject appeal." In other words, Wyoming Refining Company's evidence was ignored. Incredulously, MMS's position is that after keeping Wyoming Refining Company in the dark about the producer's audit and after allowing us to buy oil the price of which MMS knew was likely to change, MMS will, in addition, bind Wyoming Refining Company to the "secret" producer valuation proceedings held and concluded without us. MMS, therefore, believes it need not consider our evidence. Due process, if it means anything, means notice and a meaningful opportunity to challenge the agency's decision. MMS apparently would carve out an exception for small refiners who, due to the agency's failure to notify, were enticed to their detriment and likely destruction into purchasing RIK oil they would not have otherwise bought.

CONCLUSION

Madam Chairman, Wyoming Refining Company's current dire straits could have been avoided. All that is required is a policy decision that the federal government can no longer run its oil development program on the basis of prices that are never final until years after the resource has been extracted from the ground. Under current policy, every RIK purchase is a potential contingent liability to the company. In obtaining revenue from oil development, however, price finality is key. Finality is not present in the current system, and, if our case is any bellwether at all, huge sums of money are wasted redetermining oil values long after the oil itself has been consumed. As Wyoming Refining Company's experience has shown, the post production audits engendered by this inconsistent policy have unintended and severe consequences. We suspect the certain destruction of small refiners, the loss of their competitive influence in the refining industry and an increased uncertainty in defense fuel supplies may be only the beginning.

TESTIMONY OF

Robert E. Brown, Associate Director

Minerals Management Service
U.S. Department of the Interior

Before the

Subcommittee on Energy and Mineral Resources
Resources Committee

House of Representatives
September 18, 1997

Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Minerals Management Service's (MMS) examination and implementation of programs to take oil and gas royalties "in kind." In testimony submitted for the July 31, 1997 hearing on royalty in kind before the Subcommittee, MMS Director Cynthia Quarterman provided background information and a summary of the draft report of our 1997 Royalty in Kind Feasibility Study. My testimony today will focus on our future plans as we proceed toward implementing the report's recommendations. Before discussing these plans, I would like to briefly summarize the findings and recommendations of our final feasibility study report.

Final Report of the 1997 Royalty in Kind Feasibility Study

MMS released the final report on September 2, 1997. Copies were distributed to members of the Subcommittee and staff on September 3, 1997. We have brought additional copies for interested individuals present at today's hearing. The report is also available on the Internet on the MMS Home Page (www.mms.gov). The primary objective of the study was to determine if implementation of an RIK program or programs for Federal oil and gas is in the best interest of the United States, and, if so, under what circumstances. The phrase "best interest of the United States" refers to a program that would:

1. Offer potential revenue neutrality or enhancements to the U.S. Treasury; and

2. Provide extensive administrative relief for MMS and industry.

The overall conclusion of the study is that RIK programs could be workable, revenue neutral or positive, and administratively more efficient for MMS and industry. Key elements of a successful Federal RIK strategy would include:

- o Downstream Market Presence: To be revenue neutral/positive, an MMS program must strategically participate in downstream services and value enhancements, either through contracting with energy marketers or in-house marketers and associated staff.

- o Aggregation: Provision of substantial volumes could provide MMS and its marketing agent(s) with increased market opportunities primarily through assurance of supply.

- o Administrative Relief: The greatest relief would accrue under a broadly-applied, multi-year program through decreased reporting to MMS and discontinuation of audits of the producers' shares.

However, RIK programs would have reduced chances for success if implemented under the following unfavorable conditions: (1) audits of the producers' shares; (2) legislation directing MMS to take in kind for all commodities in all areas or at the lessees' discretion; (3) acceptance of production at less than marketable condition; and (4) payment of above market rates for transportation on non-jurisdictional pipelines.

The report concludes that a natural gas RIK program in the Gulf of Mexico has the greatest chance of success of any potential MMS initiative, especially if it involves substantial volumes; is long-term; engages one or several marketers; and provides a formula for MMS sharing in downstream value additions secured by MMS's energy marketer(s). The report also concludes that while detailed economic effects cannot yet be determined, such a program is anticipated to be both revenue positive and administratively more efficient for the many reasons described in the report. Accordingly, the report recommends implementing an RIK pilot program for Gulf of Mexico natural gas consistent with the key success factors described above.

For crude oil, the report concludes that the information is equivocal, and the revenue and administrative implications are uncertain. However, the report indicates there is significant interest on the part of producers, marketers, and the State of Wyoming in taking crude oil in-kind from Federal leases in Wyoming. Thus, the report recommends that a crude oil pilot--developed in concert with all affected parties--be instituted in Wyoming to test revenue and administrative effects.

Similarly, the report notes that the State of Texas has expressed a significant amount of interest in an RIK program for Outer Continental Shelf (OCS) 8(g) leases offshore from the State. Consequently, because of the potential for a successful OCS Gulf of Mexico gas program, the report recommends that MMS and Texas jointly explore the possibilities of RIK programs involving these properties.

Province of Alberta Program

The Subcommittee's August 28, 1997 invitation to MMS to participate in this hearing included a request that we describe any analyses performed by MMS comparing the current U.S. royalty management system to Alberta's RIK scheme. We have not conducted a detailed economic analysis comparing the two systems primarily because we were not presented with any source documentation or other information from the Province upon which we could verify their asserted revenue enhancement of 7 cents (Canadian) per barrel.

However, we have spent some time qualitatively assessing the implications of the Alberta crude oil RIK program in regard to U.S. production. We conclude that there are important differences between the Alberta production environment and that of onshore U.S. production areas--differences that give us pause as we consider RIK scenarios for onshore crude oil. For example, Alberta produces roughly the same amount of crude oil as currently produced from the Gulf of Mexico in a very concentrated, relatively small geographic area with a somewhat limited pipeline infrastructure and nearby refinery capacity. The situation is markedly different than onshore in the United States, with its more than 36,000 oil wells, 2,600 operators, and 23,000 producing leases scattered remotely throughout numerous geologic basins in 28 revenue-receiving States. The learning curve for the Federal Government to commence an across-the-board onshore RIK program would be prodigious, and perhaps more complex than the existing in-value system. It seems obvious to us that implementation of a new crude oil RIK system in the onshore environment would be a large and complex undertaking, one that should be attempted **only** if the revenue and administrative impacts for all parties are substantially positive.

Future Activities

Our senior management team at MMS has accepted the recommendations of the feasibility study report in concept, and we intend to proceed developing specific program models consistent with the favorable conditions previously mentioned. Our first course of action is to consult with the Administration, Congress, States, and industry on the results of our conceptual study and our next steps. During the past two weeks, we have spoken to congressional staff of Members interested in this issue. Director Quarterman has sent a formal invitation to Governor Geringer of Wyoming to join with us in a joint exploration of RIK opportunities for crude oil in that State. We have also formally invited the State of Texas' General Land Office to join us in examining potential RIK programs for Texas 8(g) leases. Lastly, we have planned a meeting with industry representatives to discuss these matters, to be held on September 22, 1997.

In regard to natural gas from the Gulf of Mexico, we will soon form an implementation project team. The team will identify the scope and overall framework of the proposed royalty marketing alliance program and will involve the oil and gas industry in the development of program details. A crucial decision point will follow and will be based on detailed economic analyses of business proposals submitted by energy marketers or developed internally. The results of the analyses will be critical to the decision on whether to implement the pilot program, a decision that will be made by the Department in conjunction with the Office of Management and Budget.

Concurrent with this process, we will be working with the States of Wyoming and Texas to identify and develop pilot programs for Federal leases in Wyoming and the 8(g) area off Texas, respectively.

I would like to reiterate and emphasize the comments made by Director Quarterman earlier this summer that we will not make any final decisions to implement programs before detailed analyses of specific programs are completed. I also want to repeat our belief that it is not wise to make legislative decisions before comprehensive analyses are conducted. Any statutory or regulatory assistance that may be necessary will depend on the specific nature of any program that is developed. At this point, it is premature to guess what type of legislative assistance, if any, may be needed.

In closing, let me state that we are enthusiastic about the prospects of implementing successful RIK programs for Federal mineral leases. We believe that such programs potentially provide an innovative way to dramatically streamline the royalty management process--in a manner that could also increase revenues for the U.S. Treasury. We are quite serious about giving the RIK concept every chance for successful implementation.

Thank you Madam Chairman and Members of the Subcommittee, this concludes my prepared remarks. I would be pleased to answer any questions you may have.

BRIEFING PAPER ON
ROYALTY-IN-KIND FOR FEDERAL OIL AND GAS PRODUCTION
SEPTEMBER 18, 1997

ISSUE

On federal lands, including the outer continental shelf (OCS), lessees make a cash payment for a portion of their production value (usually $^1/_8$ onshore, or $^1/_6$ offshore) as a royalty to the federal government. Valuation of production is a complex and burdensome process for lessee and lessor alike that has resulted in years of litigation and the establishment of a large federal government audit staff, augmented by State auditors acting under delegation of the Secretary's authority. On January 24, 1997, the Minerals Management Service (MMS) published a notice of proposed rulemaking for valuing crude oil from federal leases for royalty purposes. On July 3, 1997 MMS published a supplementary proposed rule responding to comments on the original proposal. Most recently, on September 4, 1997, MMS announced its intent to hold workshops and take comments on as-yet unannounced alternatives to the proposed rulemaking.

Recognizing the inherently inefficient and complex valuation process reduces "net" funds to the federal and state treasuries are reduced because of excessive audit resources and litigation costs borne by the government, the Subcommittee is pursing legislation to implement a Royalty-In-Kind (R-I-K) program with attendant savings to government. This is the second oversight hearing. At this follow-up to the July 31, 1997 hearing we have invited several "outside sources", including economists, consultants, a representative of private royalty owners, a refiner that has participated in the MMS refiner R-I-K program, and an oil marketer contracted to the Alberta Provincial government. A representative of the MMS will also testify about the *1997 Royalty In Kind Feasibility Study* published in August.

CRS REPORT

In July, the Subcommittee requested the Congressional Research Service to investigate the current Alberta Department of Energy oil R-I-K program. The report provides a good summary of the development and the current status of the Alberta program. A copy is attached for your review.

The last section of this report addresses "Applicability to the U.S. Crude Royalty Situation." In this section CRS suggests there may not be enough independent producers with adequate capacity from producing area to large markets for an efficient R-I-K system. Of course, these very same factors mean that crude oil from such locales is valued less than elsewhere and thus royalties-in-value on such crude are likewise diminished The CRS report contains many of the same questions the Subcommittee hopes to answer before drafting of R-I-K legislation can be completed. We will continue to work with CRS to find those answers.

CONCLUSION

Conceptually, R-I-K has bipartisan support in Congress and among state regulators, the Administration, and the industry. The complex programmatic details are where the idea becomes more controversial. From this hearing and further interaction with the MMS, the Subcommittee will determine what changes to existing law, if any, are needed to allow States with production in the OCS Lands Act Sec. 8(g) zone to take their fraction (27%) of royalty oil and gas in-kind.

The Subcommittee believes several questions need be answered before crafting legislation to implement an R-I-K program, including:

1. Can a federal R-I-K program reduce administrative costs by eliminating litigation and overhead associated with valuation of the product?

2. Can a federal R-I-K program maintain or increase revenue through a marketing advantage of its large volume of royalty oil and gas?

3. Can issues such as delivery point, marketable condition, production fluctuation and volume balancing be resolved so that marketing of the federal product remains competitive?

Attachments:
Witness list
CRS Report: Alberta's Royalty-in-Kind program

Congressional Research Service • Library of Congress • Washington, D.C. 20540

Memorandum September 16, 1997

TO : House Committee on Resources
Attention: Sharla Bickley

FROM : Marc Humphries
Lawrence Kumins
Environment and Natural Resources Policy Division

SUBJECT : Alberta's Royalty-in-Kind Program

This memo discusses the royalty-in-kind (RIK) program that is currently employed for oil production in Alberta, Canada. A brief history of the Alberta program is provided, along with a description of how the program works today. Also discussed are major criteria that might be used to evaluate the success of the program, and the program's potential applicability to the United States. Overall, the Alberta RIK program appears to be successfully maximizing revenues to the provincial government and minimizing administrative costs. Factors unique to Alberta may be responsible for at least part of that apparent success.

We hope this information will be helpful; for further questions on the topic, we can be reached at x7-7264 (Humphries) and x7-7250 (Kumins).

Introduction

Alberta oil producers pay royalties to the provincial government with a physical share of their production. This contrasts with the typical U.S. procedure, in which royalties are a percentage of the value of production and paid in cash. The Alberta system avoids disputes over the valuation of oil production for royalty purposes. But it also makes the government responsible for ensuring that its royalty oil is marketed as effectively as possible, and potentially makes the government a significant oil-market participant.

Alberta's RIK system has evolved significantly over the years. The most recent changes involved hiring private marketing firms to sell the government's oil. The current royalty-in-kind marketing process is seen by many throughout Alberta's public and private sectors as a successful effort for the provincial government, the province's oil producers, and other oil industry stakeholders.

Several criteria can be used to evaluate the Alberta RIK program. Maximizing the government's royalty revenues is one of the most important factors. The provincial government calculates that its marketing arrangements have earned it higher revenues than it would receive under a royalty system based on the value of production. Additional important criteria include administrative costs, fairness to producers, the seeming absence of fraud and abuse, and what Albertans view as an acceptable level of government involvement in oil markets.

The apparent success of the Alberta royalty system has prompted some suggestions that a similar system could be adopted in the United States. Some regional segments of the U.S. oil market bear similarities to the Alberta production and marketing situation. However, adoption of an RIK system throughout the United States would face numerous complications, particularly the federal government's ability to arrange for marketing the large amounts of oil and gas that would be involved.

Background

In Alberta, about 80% of petroleum resources, including those under private land, are owned by the "Crown"; thus, the provincial government collects royalties on most production.[1] There have been three distinct periods in the administration of Alberta's crude oil royalty program: pre-1974, 1974-1996, and post-1996. Since 1974, royalties to the provincial government have consisted of a percentage of crude oil volume produced, rather than, as typically occurs in the United States, a percentage of the dollar value of the production. The primary differences in the way the Alberta program has been administered during the past 20 years involve the disposition of the government's share of the oil. Most recently, the government has shifted from directly marketing its share of the oil to a system in which government oil disposition is handled by private-sector marketing agents.

Pre-1974 Period. The system prior to 1974 involved no government marketing. The government would sell back to selected producers its 16.6% average royalty share of production. The government never took physical possession of the oil (as it still does not), but received from producers the cash proceeds from the sale of the royalty share at market prices. Because the goverment's royalty revenues depended on the value of the oil to producers, it was effectively the same as the U.S. value-based royalty system.

Tension between the provincial and federal governments over revenues from Alberta's oil reserves grew during that period. The federal government in 1971 imposed a tax on crude oil reserves, which had the effect of raising the average royalty rate from 16.6% to 22%. Then in 1973, the federal government imposed an export tax on domestic oil production of 25 cents per barrel, which was further increased to a high of $6.40 per barrel the following year.[2]

Direct Government Marketing. By 1974 the Government of Alberta decided to take a more active role in developing its oil, establishing a provincial commission to directly market all oil produced from government-owned reserves, including producers' shares. Two factors led to this: the rapid rise in world oil prices and concern over the depletion of Alberta's natural resources. The rapid rise in prices also led the government of Alberta to

---

[1] Telephone interview with Linda White, Alberta Department of Energy, September 9, 1997.

[2] Beigie, Carl E., and Alfred O. Hero, Jr., editors. *Natural Resources in U.S.-Canadian Relations*. Vol. 1. Westview Press, 1980. p. 264.

raise its royalty rates. In response, the federal government disallowed the deduction of the provincial royalty from income for corporate income tax purposes. The federal government later increased oil exploration and development tax breaks to encourage development of Alberta's oil, and allowed domestic oil prices to rise to world levels.[3]

A basic belief by the Alberta government was that substantial government involvement would be required for the province to realize its development goals.[4] Two main tactics were employed by the provincial government: to take over the marketing of Alberta's crude oil, and to increase its regulatory powers over the production and sale of oil and gas. The Alberta Petroleum Marketing Commission (APMC) was established as the sole agent for selling any oil produced from government-owned reserves, including the "Crown royalty share" and the producers' share (Petroleum Marketing Act, Chapter P-5). Deregulation of the oil industry in 1985 reduced APMC's marketing responsibilities to only the Crown share.[5]

In the early 1990s, the lack of pipeline capacity and adequate storage became a problem for the APMC. By law the government cannot take possession of its royalty share of oil. The Crown's oil had to take priority in the marketing of all oil produced in the province. As a result, oil producers were concerned that their oil might end up in storage while Crown oil was in the market. Storage and pipeline capacity was added, alleviating the problem.

Privatization of Crude Oil Royalty Marketing. After a major restructuring in 1994, the APMC's responsibilities were limited to activities directly related to crude oil marketing. In 1996 the Alberta Department of Energy (ADOE) assumed the functions of the APMC and entered into agreements with marketing agents to market the Crown's oil.

The Alberta Ministry of Energy (which includes ADOE) regulates the development of energy resources in the province. The Ministry leases production rights for the 80% of Alberta's oil reserves that are owned by the provincial government, and requires producers to pay the government a royalty in the form of product (crude oil). The royalty rate varies by lease (or type of oil). The province has a 5-year contract with three marketing agents that take physical possession of the oil. They market the RIK oil through the various pipelines to refineries in Alberta, other parts of Canada, and the United States. The Auditor General of Alberta provides for an annual audit of the crude oil marketing/royalty-in-volume program for the government and presents its report to the provincial Energy Minister.

The three marketing agents were selected from 24 contenders. An important criterion for selection was that the marketing agent not own oil refineries. This was to ensure arm's-length transactions. The marketers are allocated their proportions based partly on the type of oil produced, i.e., light crude, sweet crude and heavy crude. The government believes the three marketing companies will control sufficient volumes of oil to receive the best pipeline rates and prices from large refineries.

The Energy Resource Conservation Board (ERCB) had been set up in 1971 to address broad concerns affecting energy resource development and depletion in Alberta. The ERCB

---

[3] *ibid.*

[4] *ibid.* p. 289.

[5] Minerals Management Service. *1997 Royalty in Kind Feasibility Study*. August 1997. p. 8.

was later renamed the Alberta Energy Utility Board (AEUB) and given jurisdiction over proposals for developing Alberta's reserves with the understanding that local needs were to be met first. Public funds could be used to subsidize or purchase industrial development projects. This policy led to the creation of the Alberta Energy Company (AEC), a private/public energy company. The AEUB, funded in part by the private sector and partly by the province, is still primarily a regulatory body for the utility and natural gas industries but also a collector of fuels and minerals production data for the ADOE and the private sector.

Current Alberta RIK System

Royalty rates in Alberta currently average 17%, but result from a complex hierarchy of rates ranging from 12% to 25%. Most recently, effective rates were 16.3% during 1994, 17.5% in 1995, and 18.9% for 1996.[6] The rates are linked to a number of factors, including:

- a three-tier well vintage structure, containing "old" oil from pre-1974 wells, "new" oil from wells drilled during the 1974-1994 time frame, and "third tier" oil, flowing from post-1994 wells;
- well productivity and production rates integrated into the royalty formula; and
- royalty rate adjustments for crude prices.

Marketing the Crown Share. For years prior to 1996, as discussed in the previous section, the staff of the Alberta Petroleum Marketing Commission had performed the task of marketing royalty crude. As a policy matter, the government wished to get out of the business of marketing oil and, at the start of 1996, contracted with three marketing entities. These are Gulf Canada Resources Ltd., PanCanada Resources Ltd., and the CANPET Energy Group Inc.

Selection criteria included the marketer's expertise, a lack of affiliation or other relationship with a refinery (in Canada or the United States), and a willingness to commingle Crown crude with its own and market that oil on the same price basis. This last criterion was designed to assure that the producer expended the same effort on behalf of the Crown as it did on its own behalf to realize the highest prices. In fact, the companies selected are basically oil production companies with a strong marketing capability and have very limited involvement in other aspects of the petroleum industry. The marketers are paid 5 cents per barrel for their services.[7]

As a provincial entity, the Marketing Commission had won respect for its marketing expertise, according to industry officials. Indeed, as royalty oil marketing was privatized, the commission staff were regarded well enough that many were hired by the three marketing firms.

---

[6] Telephone conference with Linda White, ADOE, September 5, 1997.

[7] Minerals Management Service. *1997 Royalty in Kind Feasibility Study*. August 1997. p. 9.

Marketing Implementation. Because of the limited local market for crude oil in Alberta, much production is moved to other markets via three pipeline systems. The InterProvincial Pipeline moves crude to the mid-continent area, with an important terminal in Chicago. The Express pipeline moves oil due south, connecting to the Platte Pipeline System in the United States. Finally, the Transmountain Pipeline transports oil to the West Coast, offering access to refineries in British Columbia as well as to international markets.

The Alberta DOE is proactive in matters relating to pipeline capacity and construction. It coordinates transport through pipelines, has effectively sought to relieve bottlenecks on the Interprovincial line, and has supported construction of both the Express and Transmountain systems.

With growing production — and increasing demand for Canadian crude in the United States — Alberta has sought to acquire rights to firm capacity on these facilities, thus guaranteeing access to broader markets offering liquidity, depth and world (in contrast to local) market prices. Table 1 shows 1994 to 1996 royalty crude sales revenues.

Table 1. Alberta Royalty Crude Sales 1994-6

Year	Sales (C$ billions)	Barrels (millions)
1997 (Jan.-July)	1.0	36
1996	1.9	71
1995	1.6	72
1994	1.4	66

Source: Alberta DOE

Major Performance Indicators

Based on such considerations as maximized government revenues and minimized administrative costs, and by the satisfaction expressed by most participants contacted for this report, the Alberta RIK program appears successful. While the provincial government's involvement in the oil market may have caused concern among producers in the past, that situation apparently has eased with the enlargement of total pipeline capacity.

RIK Sales Program Price Performance. Alberta produces both sweet and sour crudes; sweet crude typically sells for more than sour. Therefore, two price comparisons are called for in measuring the performance of Alberta's royalty crude marketing efforts. Comparison is made between a reference price — based on world market price measures — for each crude, computed by the consulting firm Purvin and Gurtz. The results in 1995 and 1996 indicate that RIK crude sales realized prices within a few pennies per barrel of reference. This is viewed as an excellent performance, especially when contrasted with the alternative of attempting to market crude at the lease location in the local Alberta oil market.

Total government revenues are substantial, and 1996 realizations of about U.S.$19 per barrel appear to be generally in line with world prices, especially given the remote site of production, long transport route, and the mixture of sweet and sour crudes.

Administrative Costs. Simplicity and ease of administration are generally believed to be among the strongest attributes of the Alberta RIK system. The three marketing firms selling the Crown's share of Alberta crude production carry out the task for about 5 cents per barrel. It may well be that their fee is low because there are other benefits for the firms from participating in the program. Certainly these companies become larger factors in crude markets by virtue of selling Crown crude as if it were their own, and this is likely a factor in keeping RIK marketing costs low.

Alberta DOE spends about C$750,000 per year to administer the oil RIK program, with a staff of about 17. The marketers have received C$2.3-2.7 million per year, according to the Department.[8] Those figures indicate that Alberta DOE spends a total of about C$3-3.5 million per year to collect annual RIK revenues of C$1.4-1.9 billion. A 1995 study by the Alberta Petroleum Marketing Commission concluded that the total administrative costs of the RIK program were less than they would be under most alternative royalty systems.[9]

The U.S. Minerals Management Service's oil and gas royalty program received $70 million in FY1997 to collect royalties and rents from 1,837 outer continental shelf leases, 19,770 onshore leases, and 3,754 leases on Indian lands. In 1996, MMS collected $4.3 billion in royalties and an additional $150 million in rents and other revenues. While three-quarters of revenues came from OCS oil and gas production, only 40% of the MMS revenue collection budget was expended on OCS collections. With 10 times as many leases onshore as offshore, 43% of the collection budget was expended here, despite the fact that only one-fifth of revenues were derived onshore. Collecting revenues from Indian lands was even more costly, accounting for 17% of the collections budget but only about 4% of revenue collection. These summary figures show that collecting the big-ticket OCS revenues is much less expensive than collecting from a diversity of onshore and Indian leases.[10]

With rising production — mostly from OCS lands — and prices (especially for natural gas) during 1997, higher revenues will likely result this year. This development should result in royalty collection's becoming more cost-efficient. But collection from a huge variety of onshore leases — often small and geographically remote — as well as the specialized matter of collecting from leases on Indian lands, raises the underlying cost structure of a royalty collection program which is fundamentally more complex than Alberta's.

A detailed comparison of the royalty collection costs of Alberta DOE and MMS would be required to account for all the non-comparable circumstances in the two systems; such an

---

[8] Telephone interview with Linda White, Alberta Department of Energy. September 9, 1997.

[9] Alberta Petroleum Marketing Commission. *Crude Oil Royalty Albernatives*. February 17, 1995. p. 1.

[10] Fax communication from Todd McCutcheon, Minerals Management Service Office of Policy and Management Improvement. September 15, 1997.

exercise has not been conducted. However, it is possible that such a study would find administrative cost differences under the Alberta RIK system, probably because of the relatively high auditing and adjudication expenditures inherent in the current U.S. royalty valuation system. Under the Alberta RIK program — which, it must be emphasized, has a long operating history with little acrimony among the parties — the marketers are audited, but not individual producers.[11]

Fairness to Producers. We were unable to identify specific producer complaints related to the Alberta royalty system, with the exception of producer concerns about government claims on pipeline capacity during brief periods of capacity prorationing. It would appear that has been a transitory phenomenon, however, since pipeline capacity in the region is continually expanding.

Some controversy over the Alberta RIK program also arose during the transition to private marketing of RIK oil. Press reports at the time indicated that some large producers favored a return to some form of the pre-1974 cash royalty system, perhaps similar to Alberta's current system for gas production.[12] Producers also expressed concern that the provincial government would show favoritism in selecting private marketers for royalty oil, an allegation strongly denied by government officials.[13]

Government Involvement in Oil Markets. Direct government marketing of royalty oil began during the oil supply disruptions of the 1970s, when Canada, like other nations, imposed numerous controls on its oil markets. But because most of Alberta's oil reserves were owned by the province, the federal government could not directly use the oil to affect the marketplace. As indicated by the previous description of federal-provincial tensions during that period, it appears that Alberta government's interests lay closer to those of the local oil industry. Nevertheless, there was apparently enough concern about provincial government involvement in oil markets to prompt the 1996 transfer of royalty marketing activities to the private sector.

Applicability to the U.S. Crude Royalty Situation

Could the Alberta crude oil royalty system work in the United States? There are several unique factors in Alberta that have helped the program to apparently succeed, many of which may not exist in all segments of the U.S. market — particularly the crude oil market. U.S. gas markets, with good transportation access to multiple distribution points, may provide a better fit to the Alberta model (which there is used only for oil).

Factors Leading to Alberta's Apparent Success. A number of factors combine to help the Alberta RIK program achieve satisfactory results. In addition to what amounts to a very long history of government oil ownership, Alberta oil fields cover a relatively concentrated geographic area from a pipeline transport perspective. The transport system is geared to moving oil out of a surplus area to refinery markets, many of which are quite far

---

[11] White, *op. cit.*

[12] Boras, Alan. *Producers Fight Privatization*. Calgary Herald. January 10, 1996. p. D1.

[13] Boras, Alan. *Province Presses Privatization*. Calgary Herald. January 9, 1996. p. D1.

away. Alberta has been proactive in pipeline development, ensuring capacity for movement of its own crude to larger, distant markets.

Because the local refinery market is small relative to production, Alberta has a number of independent producers with little involvement in other aspects of the petroleum industry, other than marketing their own crude. With 24 such entities bidding on the marketing of RIK crude, there seem to be an ample number producer/marketers willing to do business with the government and capable of performing arm's-length crude sales. In addition, these independents are willing to physically commingle their own crude with RIK crude, sell it on a commingled basis, and share the pooled revenues with Alberta. This arrangement may be mutually beneficial.

Two of the most important factors that seem to contribute to the Alberta RIK program's apparent success — large oil volumes and low-cost transportation — were delineated in a September 2, 1997, written response to Subcommittee Chairman Cubin by Continental Resources Inc. Continental, an independent oil producer based in Oklahoma, enhances the value of its oil by aggregating small quantities into larger-volume packages that are more attractive to buyers. Small packages of oil tend to realize lower per-barrel values, and aggregation avoids what amounts to a low-volume discount. To minimize transportation costs in situations where inadequate or overpriced transport facilities result in low crude reciepts, Continental will seek alternatives, including construction of its own facilities.

Alberta accomplishes both of those goals in its RIK program. The combination of producer/marketer and RIK crude results in a critical mass of marketable product and avoids the low-volume discount. And by exercising its governmental power, Alberta involves itself in pipelining to the extent that it eliminates costly bottlenecks between the wellhead and ultimate point of sale.

Comparison to U.S. Situation. Two special considerations exist in Alberta that have been keys to the RIK program results. These might not be present in the United States. The first is the presence of completely independent oil producers that have no commercial affiliation with other parts of the petroleum industry, except for crude marketing. These marketers have access to pipeline transport that has adequate capacity to connect producing areas to large markets. Second, the crude producer/marketers are willing to do business with Alberta for a low fee, and commingle crude revenues.

In many segments of the U.S. oil and gas market, circumstances may be quite different from those in Alberta. U.S. royalty valuation complaints often come from independent producers. These are often smaller producers — in contrast to integrated firms — located in smaller fields. These fields may be either remote from major markets and/or served by transport systems that are controlled by other firms, often integrated petroleum companies rather than open-access, common carrier-type transporters. The firms owning such pipelines many also own the refineries that are an oil field's only customers.

Complaints about valuation have come from producers who contend that local market conditions result in prices well below the world market. With MMS seeking royalties related to crude traded on recognized international markets such as the NYMEX, some producers would rather tender crude to MMS than pay a cash royalty based on prices well above field market transactions in their locality.

If MMS became a major oil owner, would the agency be able to find enough help from third-party firms solely engaged in crude marketing? Or could the necessary expertise come instead from unaffiliated smaller producers, who might want to market RIK oil to become larger players in the marketplace in addition to earning marketing fees?

And without Alberta's history of involvement in assuring the availability of open-access transport to large and competitive refinery markets, MMS RIK crude sales efforts could be hampered by the same factors causing the producers to realize below-world market prices. Would these smaller firms that might market RIK oil, as Continental itself contends, have the financial and operational capability to successfully deal with inherently difficult transport situations?

Congressional Research Service • Library of Congress • Washington, D.C. 20540

CRS

Memorandum September 17, 1997

TO : House Natural Resources Committee
Attention: Deborah Lanzone

FROM : Marc Humphries
Lawrence Kumins
Environment and Natural Resources Policy Division

SUBJECT : Royalty-In-Kind Issues

This memo discusses major issues that would be involved in the establishment of a large-scale royalty-in-kind (RIK) program in the United States. Producers of oil and natural gas on federal onshore or offshore lands currently pay royalties to the U.S. government as a percentage of the value of their production. Under a royalty-in-kind program, producers would give the federal government a physical share of their oil and gas production. RIK proponents contend that the system would reduce administrative costs and disagreements over the valuation of oil and gas production for royalty collections. However, such a system also would require an effective system for marketing the federal government's oil and gas shares and could lead to significant government involvement in oil and gas markets.

This memo begins with an overview of major policy issues that might be involved in establishing an RIK system in the United States, including a discussion of the complexities and differences in the U.S. markets for crude oil and natural gas. The current U.S. oil and gas royalty system is briefly described and basic royalty statistics presented. Options currently under consideration for the U.S. royalty system are discussed, along with potential RIK models currently in operation.

We hope this information is helpful. If we can be of further assistance on this matter, please call us at x7-7264 (Humphries) or x7-7250 (Kumins).

Policy Overview

Collection of royalties on oil and gas production from federal leases is a complex administrative task. Thousands of leases covering millions of acres must be monitored and audited to ensure that the U.S. Treasury and other royalty revenue recipients receive the monies they are statutorily due. A total of $4 billion in federal oil and gas royalties are estimated to have been collected by the U.S. Minerals Management Service (MMS) in 1996.

Major changes in the U.S. royalty system would raise numerous issues for the wide variety of public- and private-sector participants in the current program. For the federal government and other recipients of royalty revenues, the changes would have to result in collections at least as high as under the current system. For the oil and gas producers, a new system would need to provide fairness, while ensuring that their marketing arrangements would not be unduly disrupted. For the economy as a whole, the level of administrative and transaction costs would be important, as well as concerns about government involvement in energy markets.

Policy Considerations for U.S. Markets

A number of proposals for taking royalties in kind, instead of a cash royalty share, have engaged congressional interest. This interest has arisen at least partly because of seemingly successful RIK programs in Alberta and, on a smaller scale, Texas. Additionally, there is a perception that MMS is under-collecting royalties with the current cash system. And there have been a number of acrimonious disputes between MMS and producers over the value of the oil and gas upon which the royalty is based. Valuing oil or gas that is sold by the producer to an affiliated entity — a common occurrence — has created special challenges.

Additional valuation complexities involve remotely located, low -volume production, chiefly from onshore lands. The cost of transporting small quantities of hydrocarbons to distant markets is reflected in low prices at the producing lease.

The Province of Alberta has been directly involved in crude marketing for many years. Most recently, it has privatized the marketing of its royalty share of oil production, contracting with three organizations to sell the "Crown share" of the oil. The contracts were let initially by bid, which led to a round of negotiations with the finalists. Alberta was able to impose some strict criteria on its marketing agents. These firms — in addition to earning fees for service — were likely attracted to the deal because the RIK oil, which they sell as if it were their own, enlarged their share of the crude market and made them more important market participants.

Several factors having to do with the nature of Canadian marketer's business practices seem to have contributed to Alberta's success. First, the firms are completely unaffiliated with refiners, and only produce and sell oil. Secondly, the firms were willing to commingle RIK oil with their own output in a completely nondiscriminatory way, so that equal marketing efforts were expended and equal prices earned. Finally, the firms had operational and marketing expertise to be able to transport and sell crude over a wide geographic area. Much of this oil is sold to refiners in the U.S. mid-continent. But their access to pipeline transportation allows them to sell into the British Colombia and the U.S. intermountain west. As a result, Alberta RIK crude is transported from markets where supply greatly exceeds demand, reaching major refining markets where it sells for world market prices.

Alberta has been pro-active in its RIK program. In addition to many years of experience in crude marketing, the province has been actively involved in promoting the construction of two new pipelines and the expansion of capacity on the Interprovincial Pipeline — the main West-to-East transport link. The provincial government's involvement has ensured that RIK crude has equal access to transportation.

With U.S. crude production on federal lands, affiliations between producers, pipeline owners and accessible refineries are common and can result in valuation disputes. Truly independent producers often have little claim on transport and may be comparatively less advantaged in their transactions with crude buyers. In contrast to Alberta, there may be few firms that can execute crude sales on a truly arm's-length basis. Further, the pipeline situation here is different. Open-access transport is not generalized. And pipelines built by producers often are targeted to serving their own refineries, rather than a market area with broad-based, multi-firm participation.

The Alberta situation may be more reflective of OCS oil than onshore oil. While the MMS onshore royalty interest is both small and diffuse, there may be independent producers (and states owning their own royalty oil) who would find it advantageous to pool their marketing efforts with MMS RIK oil. This is an area where further research, and perhaps a market test could be informative.

The natural gas situation is quite different than that of crude oil. As described below, deregulation of U.S. gas markets has resulted in the ascendency of large number of brokers and traders who are either completely unaffiliated with other parts of the gas industry or — in the case of gas industry trading affiliates — operate at true arm's-length. And the history of gas pipeline regulation has left a legacy of open access to transport.

With large royalty interests in the offshore Gulf of Mexico and in some states, MMS would have potential to form relationships with gas marketing entities, and would likely have a variety of firms from which to choose. But, in order to be successful in RIK marketing, MMS would have to adopt commercial business practices. This may be one of the most important lessons from a 1995 RIK experiment that has been deemed unsuccessful.[1] Complicated and time-consuming bidding provisions, and terms and conditions that are not normal business practice, lower the value of any deal in the commercial world. Indeed, part of Alberta's apparent success stems from the fact that government involvement in selling oil had been so extensive that provincial officials had sufficient knowledge and expertise to privatize the whole RIK marketing effort in a very short time.

U.S. Oil and Natural Gas Markets and RIK Systems

While oil and gas are often considered in the same thought, field markets for crude oil and natural gas are in fact fundamentally different. Oil may be produced from the same field as natural gas, but it reaches its point of consumption via a path differing so greatly from the track followed by gas, that the two can realistically be thought of as completely unrelated commodities. Certainly both commodities follow price paths as different as the routes each transverses on the way to burner-tip markets.

Gas production — including that from federal lands — is transported great distances by a variety of pipeline systems on behalf of a great diversity of owners, most of which are unaffiliated with the long-distance pipelines. The long-haul pipelines are, for the most part, subject to regulation by the Federal Energy Regulation (FERC), which ensures nondiscriminatory, open access. Pipeline rates — in areas served by more than one pipeline and therefore deemed to have a workably competitive transport market — are subject to cursory tariff review. This process is the evolutionary outcome of the phaseout of years of

---

[1] Minerals Management Service. 1997 Royalty in Kind Feasibility Study. August 1997. p. 7.

utility accounting-type regulation, and amounts to a situation very close to complete deregulation.

The combination of open-access, deregulation and what has become strong competition among gas transporters has created an enlarged cohort of market participants. Among the players are a variety of brokers, traders and dealmakers who match producers with consumers. These intermediaries can be completly independent, operating as stand-alone brokers, like the Natural Gas Clearinghouse. Alternatively, intermediaries may be affiliates of another gas industry entity, but their relationship is of a truly arm's-length nature by virtue of FERC regulation.

Oil production from federal lands is less easily transported to nationwide markets. Indeed, OCS production — located in the Gulf of Mexico and California — is shipped via pipeline to refineries located relatively near the production site. Often, the production, pipeline and refineries are owned by the same firm or firms. Production of unaffiliated entities — such as RIK crude — might have a more difficult time finding its way to a market on its own, without the assistance of one of the integrated firms participating in production from the leases involved.

Both natural gas and oil are also produced from federal onshore lands. About 1.9 tcf of gas (roughly 10% of domestic output) was produced in 24 states during 1996. Total royalty interest would be about 225 bcf. While more than half came from New Mexico, this relatively small amount of gas is spread over a large geographic area. It might be difficult to package enough volume for a profitable RIK transaction, although there has been little research and very limited market tests to determine potential marketability of remotely located, small packages of RIK gas.

Onshore oil production of 330,000 barrels per day (about 5% of domestic output) results from federal lands in 25 states. Wyoming — where the federal royalty interest is only about 5,000 barrels per day — is the leading onshore producer from federal lands. The federal royalty interest for onshore oil nationally is only about 40,000 barrels per day, and this is broadly spread across the nation.

Current U.S. Mineral Royalty System

The Minerals Management Service (MMS), established in 1982 by Executive Order 3071 as part of the Department of the Interior (DOI), collects royalties for the production of oil, gas, and minerals on federal lands, including the outer continental shelf.

The Offshore Minerals Management Program administers competitive leasing on outer continental shelf lands and oversees the exploration and production of offshore oil, gas and other minerals. For 1996, MMS' Royalty Management Program (RMP) collected royalties from 1,837 oil and gas leases on offshore federal lands. For onshore federal land, royalties for production are collected from 19,770 onshore federal leases and 3,754 on Indian lands.[2]

MMS collects the overwhelming majority of federal royalties as a fixed share of the value of production from federal leases. Because the sale of oil and gas is often a complex

---

[2] 1996 MMS Mineral Revenues (draft).

transaction, determining the value of production for royalty purposes can be cumbersome and litigious. Under the Outer Continental Shelf Lands Act (43 U.S.C. 1331, et. seq.), the federal government can instead collect its royalty share in kind — as a share of the actual oil and gas production. This option is currently limited primarily to a small program that provides crude oil to disadvantaged small refiners.

Production and Revenues from Federal Leases

In 1996, the RMP collected about $4 billion in revenues from OCS oil and gas leases. Additionally, about $540 million in royalties was collected from onshore production. Royalty collections for the OCS — which are subject to various adjustments and are composed of the average of several rates — averaged 15.4% of reported "sales value" for gas and 15.2% for crude. Onshore, MMS received royalty rates of 11.4% for gas and 10.3% for oil. Six states — Wyoming, New Mexico, Colorado, Utah, Montana, and California — account for over 90% of onshore revenues.

Table 1. Federal Onshore Oil and Gas, 1996

State	Oil		Gas	
	Production (million barrels)	Royalties (million $)	Production (bcf)	Royalties (million $)
Wyoming	43.1	86.3	486.5	73.4
New Mexico	31.4	63.2	1,060.7	164.8
California	21.0	24.5	14.6	2.5
Colorado	6.6	17.9	76.3	12.7
Texas	0.6	1.4	79.4	19.4
Other	18.8	39.1	182.2	37.1
Total	121.5	232.4	1,899.7	309.9

Source: Mineral Revenues 1996 (draft), MMS

Table 2. Federal Offshore Oil and Gas, 1996

State	Oil		Gas	
	Production (million barrels)	Royalties (million $)	Production (bcf)	Royalties (million $)
Louisiana	349.1	1,019.0	3,898.2	1,455.0
California	67.8	135.7	37.8	10.3
Texas	21.1	65.0	972.9	354.7
Other	negligible	negligible	115.5	45.7
Total	438.0	1,219.7	5,024.4	1,865.7

Source: Mineral Revenues 1996 (draft), MMS.

The revenues from onshore leases are distributed to states in which they were collected, to the General Fund of the U.S. Treasury, and to other designated programs. All states except Alaska (which gets 90%) receive 50% of the revenue collected from federal mineral leases. Revenues from the offshore leases are divided among the coastal states, the Land and Water Conservation Fund, the Historic Preservation Fund, and the U.S. Treasury. The states receive 27% of the oil and gas royalties only from leases located within three miles of their seaward boundaries.

Current and Proposed Royalty Valuation Methods

The appropriate valuation for oil and gas produced on federal land has been a major issue for a number of years. Some critics charge that MMS has been collecting less than fair-market value in oil and gas royalties as a result of undervaluation of production on federal leases.

Under the current royalty system, MMS collects a percentage of the gross proceeds of oil and gas sales from federal leases. The system requires substantial auditing of producers and creates numerous disputes that must be adjudicated. Evidence has been presented during congressional hearings that the U.S. is underpaid millions of dollars in royalties as a result of its current pricing rules. The MMS initially wanted to add more auditors in the field to verify production values, but funding has not been provided.

MMS has acknowledged the undercollection problem and attempted to correct it with proposed rules for establishing a price from which to calculate the government's royalty share. Discussion has centered on replacing the gross proceeds method with one that is more closely tied to the New York Mercantile Exchange price (NYMEX) for oil. Opponents of that idea argue that the NYMEX price of crude oil does not reflect the value of the oil at the lease and that a great deal of arm's-length pricing is already taking place. The proposed rule change, issued in January 1997, was amended in July. The amended rule will be discussed at workshops throughout October 1997. A final rule may be as far off as September 1998.[3] Many producers continue to argue for an RIK system as a substitute for any new valuation method.

New rules for pricing natural gas are also being developed by the MMS. Two options were proposed in June 1997 for comment: an index price plus or minus an "X" factor, and a pricing method for natural gas used by the Norwegian government. Both options are intended to reduce the difficulty of establishing values for each lease and the corresponding need for audit and adjudication.

Under the proposed index pricing method, MMS would attempt to adjust the benchmark price to leases in various regions. The proposed "X" factor would reflect difficulties in marketing, transportation, or other regional anomalies. The "X" factor would be computed from the previous year's differences between the average indices and the average gross proceeds.

---

[3] Barber, Jeff. *MMS Plans to Open Talks With Industry Over Oil-Valuation Options.* Inside Energy/with Federal Lands. September 8, 1997. p. 11.

The Norwegian government uses a "norm" price for crude and most petroleum products, which corresponds to the value at which petroleum could have been traded between independent parties in a free market. For natural gas, contractual prices are used because of the long-term nature of the natural gas contracts. MMS would establish a pricing board and consider the procedure used in Norway: setting prices quarterly and retroactively. The pricing board would form a price band and allow for company comment before issuing its final "norm" price. The Norway model is used by Alberta, Canada, for collecting natural gas royalties.

Royalty-in-Kind Options

Collection of royalties "in kind" rather than "in value" has been proposed as fair way to eliminate disagreements over the correct valuation of oil and gas production from federal leases. Because the actual amount of production from a given well or field is well documented, the amount of oil or gas due to the government would be objectively clear to all sides. However, the government would then have to market its share as effectively as possible to ensure that revenues at least equaled those under the royalty-in-value system.

MMS Pilot Programs

MMS was asked to conduct pilot studies on how an RIK collection method might resolve the undervaluation problem. After a limited, voluntary, and generally unsuccessful RIK pilot program, MMS held several field hearings on what a successful RIK program would need to include. The August 1997 Royalty In Kind Feasibility Study resulting from those hearings recommended that MMS pursue three new pilot programs:

- a long-term (perhaps 3 years) OCS pilot to market large quantities of natural gas through private sector marketing agents;
- a joint venture pilot with Wyoming for an oil RIK program; and
- a joint effort with Texas to explore possible RIK projects involving OCS 8(g) leases offshore from Texas.

MMS estimates it will take between 6 months and 2 years to implement these recommendations. From start to finish the pilot could take up to 5 years to complete.

The proposed gas RIK pilot would involve about one-third of the natural gas production under MMS jurisdiction in the Gulf of Mexico. MMS would contract out the marketing to private-sector marketers. The agency envisions that the gas transportation system will allow RIK gas to be effectively marketed downstream, and that concentrations of RIK gas will be large enough to give marketers leverage with buyers. Agency officials estimate that the federal RIK gas in the pilot program would constitute 4-5% percent of U.S. Gulf of Mexico gas production.[4]

[4] MMS briefing for CRS. September 8, 1997.

Unresolved issues include the point at which the federal government would take ownership of its in-kind volumes, and whether the government would ever take physical possession of its production share. The latter issue raises the question of storage requirements for RIK oil, if adequate marketing arrangements, including transportation, could not be arranged.

The potential economic effects of a large-scale RIK program on U.S. oil and gas markets have yet to be fully analyzed. MMS believes that even though the volume is significant enough to get a fair market price and low transportation rates, the U.S. royalty share is not enough to cause an effect on natural gas prices.

The natural gas pilot that MMS wants to pursue was selected based on the possibility of the greatest revenue to the Treasury. The pilot with Wyoming will allow MMS to test the feasibility of an onshore crude oil RIK approach. Wyoming has been interested in administering the management of royalties from federal leases in Wyoming for quite some time. Texas has a state RIK program already in place and would like to expand its participation in RIK through the pilot that is being proposed. In all cases, the goals of the RIK system are:

- certainty in royalty shares (minimizing disputes);
- simple and efficient administration; and
- adequate marketing of RIK oil to maximize government revenues.

Need for Legislation

MMS anticipates being able to conduct further pilot RIK programs under existing law, which specifically authorizes the Secretary of the Interior to elect to receive the royalties owed the government in the form of oil or gas rather than cash (30 U.S.C. §192). However, some provisions in current law could hinder or block the implementation of the pilot RIK programs that MMS is currently considering. MMS hopes to find solutions to those problems and is not currently seeking RIK legislation.[5]

Potential legal problems for RIK pilots include: existing requirements that royalty oil and gas from each lease be sold at market value through competitive bidding; the lack of specific authority for states to market the federal royalty share; and statutory reporting requirements. Legislation introduced in the 104th Congress, the Federal Oil and Gas Royalty Simplification and Fairness Act (H.R. 1975), included provisions that addressed some of those issues, but they were later dropped.

Competitive Bidding and Fair Market Value. Under the Outer Contintental Shelf Lands Act (OCSLA), if the Interior Department takes OCS oil or gas as the government's royalty share, then the product must be sold by competitive bidding for "not less than its fair market value" (§27(c)(1)). The law defines "fair market value" as the price received for other oil and gas sold from the same lease, if such sales were made (or, if not, a price based

---

[5] Meeting with Todd R. McCutcheon, MMS Office of Policy and Management Improvement, September 8, 1997.

on other market tests). That definition appears to require MMS to determine the sales price of oil and gas from OCS leases, even if the royalty share is taken in-kind rather than in-value. As MMS noted in the RIK study:

> Did Congress really intend for the U.S. to continue to audit the lessee's share of lease production when taking in kind? With such administrative burdens, why would anyone implement an in kind program? How would it be possible for the U.S. to know the pricing details of the producer's share of lease production in "real time" so that sale of the royalty share could take it into account?[6]

To get around that problem, the MMS study raised the possibility that the OCSLA provisions could be interpreted as allowing a general determination of regional "fair market value" that could be used for broad categories of RIK sales.

The competitive bidding requirement could preclude the type of sales arrangement envisioned for the RIK pilots, in which one or more marketing agents would negotiate the sale of royalty oil and gas. The MMS royalty study suggests that the statutory requirement could be met by conducting a competitive bidding process in selecting the marketing agents, who could then follow efficient business practices in selling the government's royalty shares. Whether such an approach would withstand legal challenge is unclear.

The competitive bidding and market value requirements may also pose an obstacle to the proposed demonstration with the State of Texas, which currently provides RIK gas from state leases to state facilities at a lower price than available from alternative suppliers. Texas has proposed including OCS 8(g) royalty gas in the program, but it is not clear whether the Texas program, by selling gas to selected customers at relatively low prices, would meet the competitive bidding and fair-market value requirements for RIK gas disposition.

State Authority to Sell RIK Shares From Federal Leases. Under the Mineral Leasing Act, states receive a share of the royalty revenues from federal leases. As noted previously, Texas has requested that it receive the state's share of offshore gas in kind, while the State of Wyoming has proposed that it receive and market both the federal and state shares.

The MMS royalty report recommends that pilot programs with the two states be pursued. MMS has found no authority to allow state marketing of oil and gas from federal leases, but notes that "there does not appear to be any statutory bar to establishing joint programs."[7] Specific congressional authorization of such programs could resolve the uncertainty and provide criteria for MMS to proceed.

Other Potential Legislative Issues. MMS anticipates that private marketers would handle the marketing of federal RIK oil and gas. In addition to paying the marketing firms, the federal government might also have to pay for transportation and processing of its royalty share. However, the MMS royalty study found that the agency could not directly pay for

---

[6] Minerals Management Service. *1997 Royalty in Kind Feasibility Study.* August 1997. p. 24.

[7] MMS, *op. cit.* p. 24.

such services "without a specific appropriation for this purpose."[8] Without legislation, indirect payments may be possible through profit-sharing contracts or other arrangements, according to the study.

Questions have also arisen about the Interior Department's authority in an RIK program to reduce reporting requirements under the Federal Oil and Gas Royalty Management Act (FOGRMA). MMS currently collects detailed data on royalty payments, production amounts, and other factors that FOGRMA requires to be provided to states. The MMS royalty report concluded that the law would allow the reporting requirements for such data to be "drastically simplified" under an RIK program.[9] As with the other issues, however, legislation could help clear up doubts about that interpretation.

Existing RIK Programs

The province of Alberta, Canada, operates the largest existing royalty-in-kind program, which collects $1-$2 billion per year. A smaller program in Texas provides fuel to state facilities to reduce their costs. The operation of those existing RIK programs may provide insight into some of the issues that would be involved in developing a large-scale federal program.

Alberta Oil Program

In Alberta, about 80% of petroleum resources, including those under private land, are owned by the Crown; thus, the provincial government collects royalties on most production.[10] The province has taken its royalties in kind since 1974; the primary differences in the way the Alberta program has been administered during the past 20 years involve the disposition of the government's share of the oil. Most recently, the government has shifted from directly marketing its share of the oil to contracting with marketing agents to "privatize" the disposition system.

Program History. The Alberta government began directly marketing all oil produced from government-owned reserves in 1974, during the first of the major 1970s "oil shocks." The Alberta Petroleum Marketing Commission (APMC) was established as the province's sole marketing agent — handling both the "Crown royalty share" and the producers' share (Petroleum Marketing Act, Chapter P-5). Deregulation of the oil industry in 1985 reduced APMC's marketing responsibilities to only the Crown share.[11]

In the early 1990s, the lack of pipeline capacity and adequate storage became a problem for the APMC. By law the government cannot take possession of its royalty share of oil. The Crown's oil had to take priority in the marketing of all oil produced in the province. As a

---

[8] *ibid.*

[9] *ibid.* p. 25.

[10] Telephone interview with Linda White, Alberta Department of Energy, September 9, 1997.

[11] Minerals Management Service. *1997 Royalty in Kind Feasibility Study.* August 1997. p. 8.

result, oil producers were concerned that their oil might end up in storage while Crown oil was in the market. Storage and pipeline capacity was added, alleviating the problem.

After a major restructuring in 1994, the APMC's responsibilities were limited to activities directly related to crude oil marketing. As a policy matter, the government wished to get out of the business of marketing oil and, at the start of 1996, the Alberta Department of Energy (ADOE) contracted with three marketing entities to market the Crown's oil.

Current Alberta RIK System. The three private firms selected to market Alberta's royalty oil are Gulf Canada Resources Ltd., PanCanada Resources Ltd., and the CANPET Energy Group Inc. Selection criteria included the marketer's expertise, a lack of affiliation or other relationship with a refinery (in Canada or the United States), and a willingness to commingle Crown crude with its own and market that oil on the same price basis. This last criterion was designed to assure that the producer expended the same effort on behalf of the Crown as it did on its own behalf to realize the highest prices. In fact, the companies selected are basically oil production companies with a strong marketing capability and have very limited involvement in other aspects of the petroleum industry. The marketers are paid 5 cents per barrel for their services.[12]

Because of the limited local market for crude oil in Alberta, much production is moved to other markets via three pipeline systems. The InterProvincial Pipeline moves crude to the mid-continent area, with an important terminal in Chicago. The Express pipeline moves oil due south, connecting to the Platte Pipeline System in the United States. Finally, the Transmountain Pipeline transports oil to the West Coast, offering access to refineries in British Columbia as well as to international markets.

Table 3. Alberta Royalty Crude Sales 1994-7

Year	Sales (C$ billions)	Barrels (millions)
1997 (Jan.-July)	1.0	36
1996	1.9	71
1995	1.6	72
1994	1.4	66

Source: Alberta DOE

The Alberta DOE is proactive in matters relating to pipeline capacity and construction. It coordinates transport through pipelines, has effectively sought to relieve bottlenecks on the Interprovincial line, and has supported construction of both the Express and Transmountain systems.

[12] Minerals Management Service. *1997 Royalty in Kind Feasibility Study*. August 1997. p. 9.

With growing production — and increasing demand for Canadian crude in the United States — Alberta has sought to acquire rights to firm capacity on these facilities, thus guaranteeing access to broader markets offering liquidity, depth and world (in contrast to local) market prices. Table 3 shows 1994 to 1996 royalty crude sales revenues.

Based on such considerations as maximized government revenues and minimized administrative costs, and by the satisfaction expressed by most participants contacted for this report, the Alberta RIK program appears successful. While the provincial government's involvement in the oil market may have caused concern among producers in the past, that situation apparently has eased. However, circumstances that have helped the Alberta program achieve its goals may not be present in all U.S. market segments.

Texas RIK on State Lands

The Texas General Land Office (GLO) takes about 45% of its oil and 37% of its gas production in kind from state leases. The GLO's oil is sold at a sealed-bid auction at the royalty measurement point every six months. Under state law the GLO RIK gas program must provide gas to state facilities as an alternative to local utilities. The state sells about 1 billion cubic feet per month from 100 state leases in the Gulf of Mexico. The program has saved the state $10 million annually from decreased gas prices bypassing local utilities and increased revenues by $1 million annually for the state School Fund.[13]

The General Land Office reported that its RIK program was not a cure-all for royalty valuation disputes, but that it could reduce royalty disputes and enhance revenues for the state government. The office notes that bids for RIK oil are at a premium over posted prices. Overall, the Texas GLO regards the RIK program as successful, and wants to double the amount of natural gas taken in kind.[14]

---

[13] MMS 1997 RIK Study, *op. cit.* p. 8.

[14] Reid, Spencer. Senior Deputy Commissioner, Texas General Land Office. Testimony before the Subcommittee on Energy and Mineral Resources, House Committee on Resources. July 31, 1997.

Questions from Chairman Cubin

1. In questions posed to MMS following the July 31, 1997 R-I-K hearing, I asked for a summary of the federal government's cumulative costs associated with audit and enforcement of royalty obligations, including other Department of the Interior costs, such as the workload at the Office of Hearings and Appeals, and Justice Department resources spent in litigation on these issues. MMS did not provide this estimate, that I can see, in any of the follow-up answers received September 17, 1997. The Subcommittee would like to have this information in order to get a better handle on the real costs government-wide associated with the current valuation system.

2. The Subcommittee intends to develop legislation to accomplish a successful R-I-K program. Your comments suggest no need for legislation, although you recognize that changes to current law are needed in order to allow states' involvement, both onshore and in the 8(g). Are there other areas you recognize as requiring legislation? Are you willing to work with us to draft legislation to that end?

3. In answering a follow-up question submitted by Representative Romero-Barcelo after the July 31st hearing, and in Mr. Brown's testimony, you outlined plans for the MMS to proceed on R-I-K. Specifically, you mention preparing detailed requirements, program strategies, and analysis of impacts. Please give us a time line associated with these tasks.

4. The industry representatives I have spoken with indicate that aggregation of oil volumes would indeed enhance revenues. Is the MMS aware of this view? How did you determine that an oil R-I-K program won't work, and, how many and what type of companies did you consult with to reach that conclusion? Please continue to investigate this issue and report the responses to the Subcommittee.

5. In an offer to settle a case between private royalty owners and an integrated oil company, the transportation and overhead costs which were allowed are well above the Canadian allowance of 5 cents (C$) per barrel. Do you have any knowledge of current transportation rates, or if US marketers would be willing to work for an equivalent to the Alberta program? Please explain the MMS' view on marketing fees. Does the MMS recognize there are crude oil marketers in business today that make their profits purely from matching oil supplies with demand in the most cost-effective manner possible?

6. In your response to questions following the July 31st hearing you refer to concerns about transportation away from the lease. Does the non-discriminatory access provision on pipelines provide a vehicle for reasonable rate access to lateral lines? Does this provision apply to all leases for intra-lease/field pipelines and to rights of way on the OCS for inter- lease pipelines? Does MMS have the authority to require the leaseholder and/or right of way owners to comply with the OCSLA requirements? Does the citizen suit provision of the OCSLA grant a right to the R-I-K marketer to insist on non-discriminatory access to non-jurisdictional pipelines? Would MMS consider as part of regulations promulgated under R-I-K a request that non-jurisdictional pipelines publicly declare their rates in order for MMS and/or its marketers of R-I-K product to assess transportation economics?

<u>**Questions from Mr. Romero-Barceló**</u>

1. Mr. Brown, one of the concerns expressed by representatives of the petroleum industry relates to a phrase in the proposed rule suggesting that the lessee has a "duty to market" the product. How do you interpret this phrase, or, what does MMS mean by this?

2. Currently, MMS does not allow lessees to deduct the costs of marketing oil and gas, or the costs associated with placing oil and gas "in a marketable condition." Part of the rationale for supporting a "royalty-in-kind" proposal, is that the producer, or royalty payor, would be absolved of paying those costs. Instead, MMS would absorb the costs of aggregating, transportation, and the other costs associated with marketing oil and gas. Does the MMS agree with this part of the proposal?

3. The Alberta program excludes from consideration crude oil marketers who are affiliated with refiners. What is your opinion -- should the U.S. Government also preclude such marketers?

4. We note that MMS does not endorse widespread implementation of an "in-kind" program for crude oil.

   We also note that the response from the State of Texas to a question from Chairman Cubin, that, and I quote, "If the companies all paid royalties based upon the methodology accepted in the recent settlement [between Texas and Chevron], the R-I-K program would become more revenue neutral...The bottom line is that our state in-kin programs would not exist if royalty payments were based on the market value of oil."

   What are the implications of this statement for Federal oil in-kind programs?

5. Mr. Brown, we appreciate the lengths to which MMS has gone to accommodate the petroleum industry's concerns about the proposed crude oil valuation rule. However, we believe it is important to amend the existing rule so that MMS does not rely on "posted prices" for determining the value. Can you assure the Subcommittee that the MMS will complete the rulemaking process and not allow it to languish?

7. Mr. Linden's testimony maintains a fallacy about the crude oil regulation currently under development. The industry, for obvious reasons, would like people to believe that the proposed rule would require *all* royalty valuations to be based on the New York Mercantile Exchange (NYMEX) index -- which would require net backs that would -- if true -- be unfair and difficult to accomplish for some producers.

   However, the proposed rule maintains the use of "gross proceeds" in all arms-length sales and suggests use of the NYMEX as a benchmark in only a few instances. Please, for the record, clarify this issue.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

OCT 23 1997

BY SPEC MESSENGER

Honorable Don Young
Chairman, Committee on Resources
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to enclose responses to questions submitted to the Minerals Management Service as followup to the September 18, 1997, hearing on Royalty-in-Kind issues.

Thank you for the opportunity to provide this material to the Committee. If you have any further questions or need additional information, please let us know.

Sincerely,

Cynthia Quarterman
Director

Enclosure

cc: Honorable George Miller, Senior Democratic Member, Full Committee
Honorable Barbara Cubin, Chairman, Subcommittee on Energy and Mineral Resources
Honorable Carlos Romero-Barceló, Senior Democratic Member, Subcommittee on Energy and Mineral Resources

ROYALTY IN KIND HEARINGS-SEPTEMBER 18, 1997
FOLLOW-UP QUESTIONS AND ANSWERS

Questions from Chairman Cubin

1. **In questions posed to MMS following the July 31, 1997 R-I-K hearing, I asked for a summary of the federal government's cumulative costs associated with audit and enforcement of royalty obligations, including other Department of the Interior costs, such as the workload at the Office of Hearings and Appeals, and Justice Department resources spent in litigation on these issues. MMS did not provide this estimate, that I can see, in any of the follow-up answers received September 17, 1997. The Subcommittee would like to have this information in order to get a better handle on the real costs government-wide associated with the current valuation system.**

The Department's costs for audit and enforcement of royalty obligations total approximately $28 million for FY97. This includes Royalty Management Program audit and enforcement costs of about $26 million, Interior Board of Land Appeals costs of $150 thousand, Office of the Solicitor costs of $400 thousand, and MMS Appeals Division costs of $1.3 million. As you may know, litigation on behalf of the Department of the Interior is handled by the Department of Justice. We are not in a position to provide the Department of Justice costs associated with litigating the issues. It is our understanding, however, that the Department of Justice does not routinely calculate the costs of individual cases, and therefore does not keep records in the form you request.

We caution that even under the best-designed R-I-K program not all litigation costs would disappear. Litigation cost savings would depend on the type and scope of oil or gas R-I-K programs implemented, and litigation costs would continue for Indian, solid, and geothermal minerals that are not taken in kind. Further, expected reductions in auditing costs would be deferred for at least six years as auditors complete reviews of prior periods.

2. **The Subcommittee intends to develop legislation to accomplish a successful R-I-K program. Your comments suggest no need for legislation, although you recognize that changes to current law are needed in order to allow states' involvement, both onshore and in the 8(g). Are there other areas you recognize as requiring legislation? Are you willing to work with us to draft legislation to that end?**

We maintain that we do not need any legislation to accomplish a successful RIK program at this time. We believe that by cooperatively working with States and industry we can create a successful program that is in the best interest of the Government, as well as create benefits to States and producers. We do not need legislation to have States' involvement in any RIK program and will work with them to define their involvement.

We maintain RIK legislation is premature. After our detailed analysis of the proposed pilots is complete, we will suggest any legislation that we deem necessary to implement RIK to the mutual benefit of the States, industry and the Federal Government.

3. **In answering a follow-up question submitted by Representative Romero-Barceló after the July 31st hearing, and in Mr. Brown's testimony, you outlined plans for the MMS to proceed on R-I-K. Specifically, you mention preparing detailed requirements, program strategies, and analysis of impacts. Please give us a time line associated with these tasks.**

We are establishing an implementation team which will define a detailed time line, after consultation with affected States and producers. Overall, we anticipate that the Wyoming oil pilot will take up to 12 months, and a potential offshore gas program would need up to 24 months.

4. **The industry representatives I have spoken with indicate that aggregation of oil volumes would enhance revenues. Is the MMS aware of this view? How did you determine that an oil R-I-K program won't work, and, how many and what type of companies did you consult with to reach that conclusion? Please continue to investigate this issue and report the responses to the Subcommittee.**

We did not conclude that an oil RIK program won't work, as evidenced by our willingness to work with the State of Wyoming, oil producers, and oil purchasers to develop an RIK pilot. We have concerns that if not properly constructed an oil RIK program could reduce revenues. Over the course of our Feasibility Study, we consulted with over 250 representatives of independent producers, major affiliated producers, small purchasers, non-affiliated marketers (mid-sized and the largest in the country) and integrated refiners. The consensus view is that offshore production contains a wide variety of crude oil qualities and types. Most purchasers of crude are looking for specific crude types to meet their refining needs at a given time. Offering all offshore crudes together in one lot limits the ability to meet these specific needs. Aggregation, therefore may only provide value up to a point. Any RIK program developed by the Federal Government needs to find that point where value is provided by both aggregation and detailed marketing of specific crudes. Those suggesting an oil RIK program could be revenue positive were found to compare potential revenues against lease values reflecting posted prices which tend to underestimate the proper royalty value of oil.

5. **In an offer to settle a case between private royalty owners and an integrated oil company, the transportation and overhead costs which were allowed are well above the Canadian allowance of 5 cents (C$) per barrel. Do you have any knowledge of current transportation rates, or if US marketers would be willing to work for an equivalent to the Alberta program? Please explain the MMS' view on marketing fees. Does the MMS recognize there are crude oil marketers in business today that make their profits purely from matching oil supplies with demand in the most cost-effective manner possible?**

Some marketers we talked to indicated marketing fees far in excess of the Alberta fee. Regardless, we see any fee as being a part of the contracting function and being subject to negotiation or part of the selection criteria in choosing a marketer. While we recognize there are crude oil marketers who earn profits by cost-effectively matching supply and demand, we note that the number of marketers is shrinking. Producing companies, increasingly developing their own marketing capabilities, have made it an increasingly competitive market. The resulting reduction in arbitrage opportunities and thin trading margins suggest that any revenue gains at the margin may be offset by additional costs.

6. **In your response to questions following the July 31st hearing you refer to concerns about transportation away from the lease. Does the non-discriminatory access provision on pipelines provide a vehicle for reasonable rate access to lateral lines? Does this provision apply to all leases for intra-lease/field pipelines and to rights of way on the OCS for inter-lease pipelines? Does MMS have the authority to require the leaseholder and/or right of way owners to comply with the OCSLA requirements? Does the citizen suit provision of the OCSLA grant a right to the R-I-K marketer to insist on non-discriminatory access to non-jurisdictional pipelines? Would MMS consider as part of regulations promulgated under R-I-K a request that non-jurisdictional pipelines publicly declare their rates in order for MMS and/or its marketers of R-I-K product to assess transportation economics?**

These questions are complex and require careful analysis before we can answer them. At this time, technical experts in our Offshore Minerals Management Program and the Office of the Solicitor are researching the domain of MMS's jurisdiction over non-discriminatory access and ratemaking for offshore pipelines. As you are probably aware, issues regarding ratemaking have historically been under the exclusive jurisdiction of the Federal Energy Regulatory Commission (FERC). We will provide you the results of our analysis as soon as it is available.

__Questions from Mr. Romero-Barceló__

1. **Mr. Brown, one of the concerns expressed by representatives of the petroleum industry relates to a phrase in the proposed rule suggesting that the lessee has a "duty to market" the product. How do you interpret this phrase, or, what does MMS mean by this?**

   The MMS interprets "duty to market" as the implied duty of Federal lease terms to market crude oil production for the mutual benefit of the lessee and lessor. "Duty to market" thus includes the lessees obligation to get the best possible price for the lease production. It does not mean the lessee must market its production at a distant point such as Cushing, Oklahoma. It is not true, as industry would suggest, that the "duty to market" language in the currently-proposed oil valuation rule represents a new concept. Various court cases over the years have upheld the notion that the lessee must market to the mutual benefit of both itself and the lessor.

2. **Currently, MMS does not allow lessees to deduct the costs of marketing oil and gas, or the costs associated with placing oil and gas "in a marketable condition." Part of the rationale for supporting a "royalty-in-kind" proposal, is that the producer, or royalty payor, would be absolved of paying those costs. Instead, MMS would absorb the costs of aggregating, transportation, and the other costs associated with marketing oil and gas. Does the MMS agree with this part of the proposal?**

   We agree that MMS would be required to absorb the cost of marketing oil and gas, as you suggest. Under the terms of the lease, the royalty owner does not incur these costs when paid in value. The concept behind taking product in kind is that it would be in the best interest of the lessor to market for itself. When the royalty is paid in kind, generally the producer's responsibility ends prior to marketing. However, the producer would still be required to deliver the royalty portion in marketable condition.

3. **The Alberta program excludes from consideration crude oil marketers who are affiliated with refiners. What is your opinion--should the U.S. Government also preclude such marketers?**

   This is an important issue on which we have not yet formed an opinion. Alberta has few refiners and few local markets. Thus, this requirement doesn't appear to exclude many from bidding on the oil. In many parts of the U.S. we are concerned that such an exclusion would eliminate most of the potential bidders for our oil, reducing the competition that we seek. However, we recognize that including fully integrated refiners may also raise competitiveness issues.

4. **We note that MMS does not endorse widespread implementation of an "in-kind" program for crude oil.**

We also note that the response from the State of Texas to a question from Chairman Cubin, that, and I quote, "If the companies all paid royalties based upon the methodology accepted in the recent settlement [between Texas and Chevron], the R-I-K program would become more revenue neutral...The bottom line is that our state in kind programs would not exist if royalty payments were based on the market value of oil."

What are the implications of this statement for Federal oil in-kind programs?

Texas' statement concerning revenue summarizes our position concerning oil RIK. The regulatory solution to oil valuation we have proposed reflects the market value to which Texas speaks. Most RIK solutions offered to date require the royalty owner to incur costs that are not incurred when paid in value. Our study questions whether an oil RIK program can provide additional value to overcome these additional costs. One purpose of the proposed oil RIK pilot is to see if we can answer this important question.

5. **Mr. Brown, we appreciate the lengths to which MMS has gone to accommodate the petroleum industry's concerns about the proposed crude oil valuation rule. However, we believe it is important to amend the existing rule so that MMS does not rely on "posted prices" for determining the value. Can you assure the Subcommittee that the MMS will complete the rulemaking process and not allow it to languish?**

First, let me assure you that the proposed rule does not rely on posted prices in any way for the royalty valuation of Federal crude oil, and we believe we are moving as quickly as possible given this complicated issue.

As you know, MMS published a proposed rule on January 24, 1997. The public comment period ended May 28, 1997, with the rule generating over 2,500 pages of comments. Based on feedback received during the comment period, MMS made certain modifications and published a supplemental proposed rule on July 3, 1997. Comments were due by August 4, 1997. Again, MMS received substantial comments.

Some of the comments on the proposed and supplemental proposed rules suggested alternative valuation methods. On September 22, 1997, MMS reopened the comment period to receive input on these alternatives and other new suggestions. Due to additional concerns from the public, MMS decided to extend the comment period again, until November 5, 1997.

In conjunction with the reopened comment period, MMS scheduled seven workshops to get further input on the valuation alternatives. Two of these workshops--in Denver and Houston--were held on September 30, October 1, and October 7-8, 1997, respectively. Participants included State and industry representatives, and the public was invited to attend. The third workshop, to get input on the valuation alternatives from the general public, was held in Houston on October 14, 1997. Three other workshops were held in Bakersfield, California, and Casper, Wyoming, on October 16, 1997, and Roswell, New Mexico, on October 21, 1997. These three workshops were intended to summarize for independent oil producers the contents of the proposed rule and the valuation alternatives and to receive their comments. A final workshop was held in Washington, D.C. on October 27, 1997, and was open to the general public.

Once the comment period ends on November 5, 1997, MMS intends to review the written comments received, together with input from the workshops, and issue a further proposed rule for public comment. After addressing comments received on the further proposed rule, MMS intends to develop a final rule as quickly as possible.

6. **Mr. Linden's testimony maintains a fallacy about the crude oil regulation currently under development. The industry, for obvious reasons, would like people to believe that the proposed rule would require all royalty valuations to be based on the New York Mercantile Exchange (NYMEX) index--which would require net backs that would--if true--be unfair and difficult to accomplish for some producers.**

However, the proposed rule maintains the use of "gross proceeds" in all arms-length sales and suggests use of the NYMEX as a benchmark in only a few instances. Please, for the record, clarify this issue.

The proposed rule permits royalty payments based on "gross proceeds" wherever true arm's-length sales occur. It is true, however, that the rule as currently proposed defines which transactions may be considered arm's length. The supplementary proposed rule substantially expands the circumstances under which payors could use gross proceeds. Under the supplementary proposed rule, payors would pay on gross proceeds except when: (1) their contract does not reflect the total consideration received for the production, (2) they breach their duty to market to the mutual benefit of the lessee and lessor, (3) they refine or sell their oil to an affiliated refiner, (4) they dispose of oil under a non-arm's length exchange agreement or under multiple exchange agreements, (5) they maintain an overall balance with their purchaser, or (6) they sell their oil under the exercise of a noncompetitive crude oil call. Based on input from the workshops described in question 5, the ongoing rulemaking process will further define the specific cases where royalties are payable based on gross proceeds.

Questions from Chairman Cubin

1. The fourth point on page 3 of your written testimony implies that States which opt to take their share of the royalties owed in-kind would get a better deal than those that accept their share in-value, even when the value was obtained via sale of federal R-I-K product. Do you believe this should be the case for coastal States with OCS Sec. 8 (g) revenues, as well? How would you propose that MMS handle R-I-K on federal acquired lands leases where typically the revenue split is 25% to the state or local government rather than 50%?

Questions from Mr. Romero-Barceló

1. The State of Wyoming recently offered to sell its state royalty oil by competitive bid. We understand that the results of the bidding process were not positive. Please explain why that R-I-K effort failed.

2. The State of Wyoming's severance and ad valorem taxes are applied to a large volume of oil and gas within the State. We understand that if Wyoming were to take its severance and ad valorem taxes in kind on that volume, it would equal approximately the same amount of product MMS would take in kind under its federal leases. Together, this would be a significant amount of oil and gas and would create market leverage that Wyoming's producers certainly do not have today. What is your opinion of such an endeavor?

3. Director Quarterman's written testimony suggests that MMS is willing to develop a pilot R-I-K project with Wyoming. Is the State of Wyoming willing to work closely with the MMS and form a joint team to identify and develop a mutually beneficial R-I-K program?

4. Do you believe an R-I-K program would have to be completely mandatory?

5. You stated that the States must have the option of taking their 50 percent share of gross receipts to market themselves. In a market such as Wyoming, with scattered leases, would that be cost effective? And, would you run the risk of diminishing the market power gained by aggregating a substantial volume of oil and gas?

<u>Questions from Mr. Romero-Barceló</u>

1. In the past you testified in support of the Royalty Fairness Act, which President Clinton signed into law last summer. The Congress went to some trouble and expense to enact that new law -- largely at the oil and gas industry's insistence -- and over the initial objections of the MMS.

The new law is supposed to make the royalty management program work better; in fact the MMS has spent a good deal of time and taxpayers money changing its rules and policies to accommodate the new law.

So it is disconcerting to hear you suggest that we replace it -- essentially discard the entire program -- with this radical idea to move the government into the oil business. Help us understand why the changes made by the Royalty Fairness Act, just last year, are not sufficient.

2. During the hearing, you said the Royalty Fairness Act changed the procedures of the royalty management program, and that the R-I-K proposal was about something else entirely. What procedures currently operative (or scheduled to go in effect pursuant to the Royalty Fairness Act)in the royalty management program would still be operative if R-I-K were implemented as you recommend?

3. Mr. Nichols, we understand that the Province of Alberta in Canada reports only marginally positive revenues from its R-I-K program in which marketers sell Crown oil. We understand that this increment results from taking crude oil from remote areas with few refineries and low demand to areas of higher concentration of refineries and refining demand. Why do you believe that the same dynamic could work for the U.S. Gulf of Mexico crude oil or gas?

4. All of the major oil producers are missing from the list of organizations that you represented at the hearing. With their complex marketing and affiliated companies, they would appear to have the largest administrative savings from a simplified R-I-K program. How do they perceive the R-I-K program? Please name the major oil companies that have endorsed your proposal.

5. Another law recently enacted authorized the federal government to "get out" of the oil business by assigning development and production responsibilities to a private company. This situation, at Elk Hills, is as you know, not without controversy. Do you see any inconsistency in moving the federal government out of Elk Hills and other areas where the private sector is at least equally capable of doing the job, and an R-I-K program that would, as Chairman Cubin and Rep. Thornberry favor, get the MMS into the oil market?

6. If MMS were to implement R-I-K, would Devon Energy qualify or compete for one of the marketing contracts?

Questions from Chairman Cubin

1. What are the requirements of your programs for State lessees to deliver product in marketable condition?

   In general, our leases require the lessee to deliver the product without deduction for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting, and otherwise making the product ready for sale or use.

2. What is the magnitude of cost savings for Texas by requiring lessees in your coastal waters to deliver R-I-K oil and gas to an onshore facility point? Has this always been a requirement of Texas law? If not, did competition for coastal leases diminish when it was added?

   With reference to the answer to question number one, the lessee is only required to make the product ready for sale or use which does not necessarily mean delivery to an onshore facility. In some instances the gas is ready for sale at the platform . In fact, we are taking delivery of some in-kind gas volumes offshore. The agency's royalty policy has always been to be paid on gross value of production without deductions. Clearly the state reaps the benefit of the lease terms disallowing deductions to the point of delivery but we do not maintain records on items not deducted. However, we estimate cost savings as several million dollars per year.

3. The written testimony of MMS mentions a recent settlement between GLO and an integrated oil company on a valuation dispute, and concludes that the oil R-I-K program in your State may no longer be as "revenue-positive." One benefit I see of having an R-I-K program is that R-I-K sales provide another measure of value against which to compare those leases which at still paying in-value rather than in-kind, for one reason or another. A truth serum, so to speak. How would you characterize the effect of the settlement which MMS mentions?

   We agree there is a benefit of comparing the R-I-K revenue to the value paid by the producer. In fact, one factor in our pursuing the oil valuation suit was the premiums we were receiving in our in-kind sales. However, we cannot assume that the proceeds of such sales equal market value. The superior marketing expertise of the major oil companies will likely yield a higher price. Immediately after the filing of the suit, postings in general rose dramatically. If the companies all paid royalties based upon the methodology accepted in the recent settlement, the RIK program would become more revenue neutral, consequently we will continue to monitor the program to be sure it is cost effective. The bottom line is that our state in-kind oil program would not exist if royalty payments were based on the market value of oil.

Questions from Mr. Romereo-Barceló

1. Has the Texas RIK oil program been over time a revenue enhancer? What have the recent trends been in the revenue results of oil RIK in Texas? Have you seen any lessening of revenues with respect to posted prices or market indices?

State revenue has been enhanced through the oil program in the amount $5 million since 1988. Since the early '90s we have experienced some decreases in revenue enhancement. In addition, since the announcement of the oil lawsuit in July '95 we have seen changes in postings for Yates Field.. The month following the lawsuit the margin between Marathon's posting and Exxon's (RIK purchaser) decreased to the point where the contract started losing money. The contract was eventually re-bid to a new purchaser which resulted in positive earnings.

2. Texas has made a settlement with a large producer [Chevron] on valuation for royalty purposes. How does the settlement price compare with what you receiving on your RIK oil sales?

   See our response to Chairman Cubin's question number three.

3. Since the inception of the direct gas marketing program to state facilities, have the local distribution companies accepted the challenge of competition? Are they now providing more competitive rates to the facilities? Has your margin or markup on the price you charge the facilities decreased as a result of any such competition?

   The gas industry has changed alot since we first implemented the agency program in 1985. Local distribution companies (LDC) now compete for customers by supplying gas from their marketing affiliates and transporting the same through their distribution lines. Some LDCs are more progressive than others but in general we have seen a reduction in the local retail rates which has caused us to lower our rates to the agencies.

4 Does Texas get a premium on the RIK oil it takes as in-kind payment from Marathon's Yates field when it sells the oil?

   Over the last two contracts periods (12 months) Yates Field has received an average premium of $.45 resulting in $361,145 revenue enhancement. Results of the current contract will not be known until the contract terminates in November.

5. Do you believe a RIK would have to be completely mandatory?

   We do not believe the RIK program should be mandatory. The program should be driven by economic factors. It is reasonable to take the product in -kind if it will result in more revenue. There may be a number of practical limitations that influence whether it is cost-effective to take royalty in-kind. In our experience, it is unrealistic to believe that 100% of all production could be taken in-kind. We consider several factors when selecting leases for in-kind purposes. In our end-user gas program, we not only look at the current value of the gas but we also consider the quantity of the production, what pipeline is transporting, and cost of transportation to the customer when selecting a lease. For oil, the main consideration is whether we will make more revenue through the bidding process. The volume of production is also a factor in the oil program. We generally do not take oil in-kind if the production of the well is less than 10 barrels per day.

6. Is the Texas program mandatory?

No. Please see the response to question number five for more details.

7. If MMS were to implement an RIK program, what role would Texas play? Would Texas participate only as far as the 8(g) leases go? How much revenue do these leases generate? Would it be cost effective for Texas and MMS to take royalty in kind on these leases?

Texas continues its interest in receiving 8(g) gas in-kind, including our interest in forming an agreement with MMS to sell both parties' in-kind gas as one package from respective leases. For the federal fiscal year 1996, Texas received $9.2 million from MMS for the 8(g) leases. We believe it would be cost effective for Texas to take its share of gas in-kind.

8. MMS currently has the authority to take royalty in kind "on demand." Has Texas ever considered asking MMS about developing an RIK for its 8(g) leases? If so, what was the MMS response? If not, why not?

Texas has generally explored the concept with MMS but the response has been lukewarm.

1. In the past you testified in support of the Royalty Fairness Act, which President Clinton signed into law last summer. The Congress went to some trouble and expense to enact that new law--largely at the oil and gas industry's insistence--and over the initial objections of the MMS.

The new law is supposed to make the royalty management program work better; in fact the MMS has spent a good deal of time and taxpayers money changing its rules and policies to accommodate the new law.

So it is disconcerting to hear you suggest that we replace it -- essentially discard the entire program -- with this radical idea to move the government into the oil business. Help us understand why the changes made by the Royalty Fairness Act, just last year, are not sufficient.

No one is suggesting that we discard the Royalty Fairness Act ("Act"). No one is suggesting that we move the government into the oil and gas business. We are merely continuing the process we started with the Act. The MMS also recognizes that the re-engineering process needs to continue. The MMS recently proposed discarding their entire method of valuing oil for royalty calculation purposes. The industry simply believes that Royalty In Kind ("RIK") may be a much better method that can generate more royalty revenue to the government at less cost to both the government and the industry.

I believe that re-engineering royalty collections is a two step process. Over $4 billion of royalty revenues are flowing into the Treasury each year. The Act, with or without RIK, was needed to immediately improve antiquated and burdensome royalty accounting practices. The Act prevented taxpayer dollars from being spent on unneeded bureaucratic processes. The Act accomplished this by implementing sound accounting practices such as a statute of limitations, expedited appeals process, leveling the playing field for overpayments and associated interest, delineating liable parties, eliminating unneeded steps for marginal wells and delegating more responsibilities to states. Without the Act, taxpayers would not being receiving their royalty dollars sooner.

The Act reformed MMS' accounting practices. It did not reform MMS' core business practice of determining if the proper amount of royalties have been paid to the government. A valuation system that is currently fraught with dispute and uncertainty, as evidenced by MMS' recent decision to pull its proposed rule on gas valuation and issuance of a highly complex proposed rule on oil valuation. The Act did not address valuation matters. To do this, one must start with a blank piece of paper to determine how best to design a valuation system that is efficient, does not promote disputes, and honor lease terms and requirements.

As the Committee will recall, early versions of the Act contained RIK language. This language was eliminated from the Act due to the Senate Byrd rule, not due to the desires of industry nor MMS. All parties agreed, as indicated in testimony delivered by industry and MMS during the 104th Congress, RIK remained a viable alternative for complete reform of the royalty payment system. The language contained in the original drafts of the bill would have provided MMS much more authority to pursue a new complete new approach to royalty collections. At that time, no one was arguing that RIK provisions somehow negated the needed for the rest of the Act.

All we are doing today, is picking up from were we left off during the 104th Congress. Industry, MMS and states are pursuing RIK as a possible solution to ongoing disputes regarding valuation. In the meantime, as we pursue this re-engineering effort, the government is performing its royalty accounting practices in a much more efficient and cost-effective manner.

2. During the hearing, you said the Royalty Fairness Act changes the procedures of the royalty management program, and that the RIK proposal was about something else entirely. What procedures currently operative (or scheduled to go in effect pursuant to the Royalty Fairness Act) in the royalty management program would still be operative if RIK were implemented as you recommend?

Even if a nationwide RIK program is implemented, some royalty payments are likely. For very marginal wells and/or extremely remote locations, RIK may not be practical, and the lessee is likely to have to continue to submit a royalty payment. Anytime a royalty payment is submitted to the government, all of the provisions of the Act will apply.

However, if all cash payments for royalties are eliminated through an RIK program, many of the provisions of the Act will still apply. Delivering royalty volumes to the government is an obligation as defined under the Act. For any obligation, matters such as a statute of limitations, appeals, and liability will apply. For over- and underbalances in a given month, one option may include a cash-out, as is done in the market place today. With a cash-out, money will move between the lessee and the government. With exchange of cash, many of the provisions of the Act will apply, especially with regard to refunds and interest. The Act is compatible with RIK.

The marginal well provision of the Act will be critical for future RIK efforts. This provision provided flexibility for managing royalty payments in a cost-effective manner. As RIK is considered for marginal properties, this provision could help provide the necessary authority to allow for alternative systems that are more cost effective for the taxpayer.

3. Mr. Nichols, we understand that the Province of Alberta in Canada reports only marginally positive revenues from its RIK program in which marketers sell Crown oil. We understand that this increment results from taking crude oil remote areas with few refineries and low demand to areas of higher concentration of refineries and refining demand. Why do you believe that the same dynamic could work for the U.S. Gulf of Mexico crude oil or gas?

This is not my understanding of the Canadian program. When compared to royalties that would have been paid, the program has resulted in increased revenues at a much lower cost. Be it a marginal increase or not, it is an increase of revenue and a lower cost to the taxpayer. This should be the goal of all government programs.

I have attended a couple of presentations from representatives from the Alberta RIK program. They state that their increased revenues has resulted due to aggregation of volumes and combining their crude with production streams that are already being marketed.

These latter two conditions hold much promise for the Gulf of Mexico. For the Gulf of Mexico, the MMS royalty volumes are competitive with some of the largest producers of oil or gas in the Gulf of Mexico. By aggregating these volumes, MMS will realize market power. In fact, the volumes are so centrally located, these benefits should resolve concerns you may have about not realizing uplift by moving production to more actively markets. Additionally, if MMS combines its production with the production of competitively selected marketers, even more benefit may be realized. It is a false conclusion to say because the crude is being moved in a different market, the MMS can't be successful in the Gulf of Mexico.

4. All of the major oil producers are missing from the list of organizations that you represented at the hearing. With their complex marketing and affiliated companies, they would appear to have the largest administrative savings from a simplified RIK program. How do the perceive the RIK program? Please name the major oil companies that have endorsed your proposal.

To date, a number of associations including the American Petroleum Institute, Mid-Continent Oil and Gas Association and the Rocky Mountain Oil and Gas Association, representing most of the major oil companies, support the six RIK principles. By having these types of associations endorsing the RIK principles, eliminates the need to individually list any major company. All producers, majors and independents, believe that through a properly designed program, RIK will certainly create significant administrative efficiency.

5. Another law recently enacted authorized the federal government to "get out" of the oil business by assigning development and production responsibilities to a private company. This situation, at Elk Hills, is as you know, not without controversy. Do you see any inconsistency in moving the federal government out of Elk Hills and other areas where the private sector is at least equally capable of doing the job, and an RIK program that would, as Chairman Cubin and Rep. Thornberry favor, get the MMS in to the oil market?

You discuss Elk Hills as an effort to get the government out of the oil business by moving these responsibilities to the private sector. This is what we are doing with the pursuit of RIK, attempting to determine if there is a way to get the government out of the business of chasing federal molecules through the marketplace and trying to second guess market transactions. Our recommended RIK approach accomplishes this by requiring MMS to competitively contract its marketing activities with qualified third parties. In this way, we are essentially doing what you discuss in the Elk Hills situation, by "privatizing" the federal oil and gas royalty system. By competitively hiring a private company to do all the marketing, in no way is MMS entering into the oil and gas business.

6. If MMS were to implement RIK, would Devon Energy qualify or compete for one of the marketing contracts?

No, Devon would not qualify or compete for one of the marketing contracts.

STATE OF WYOMING
OFFICE OF THE GOVERNOR

JIM GERINGER
GOVERNOR

August 26, 1997

STATE CAPITOL BUILDING
CHEYENNE, WY 82002

Dear Chairman Cubin:

I appreciate the opportunity which you provided to me to testify before the Subcommittee on Energy and Mineral Resources on the issue of Royalty In-Kind which is so important to the State of Wyoming. I am pleased to respond to the additional questions raised by you and by Representative Romero-Barcelo.

Questions from Chairman Cubin

1. The fourth point on page 3 of your written testimony implies that States which opt to take their share of the royalties owed in-kind would get a better deal than those that accept their share in-value, even when the value was obtained via sale of federal R-I-K product. Do you believe this should be the case for costal States with OCS Sec. 8(g) revenues, as well? How would you propose that MMS handle R-I-K on federal acquired lands leases where typically the revenue split is 25% to the state or local government rather than 50%?

Response:
Coastal states with OCS Sec. 8(g) revenues who get 27% of royalty income distribution could probably not significantly enhance value by marketing their own R-I-K share, assuming that the MMS costs for aggregation and marketing are competitive. Furthermore, it is my understanding that net revenue sharing cost deductions are not applicable to these royalties. However, these states could see net gains from a successful R-I-K program administered by MMS.

Federal acquired lands with a 25% state royalty share are subject to net revenue sharing costs. They could be handled just the same as other federal lands so long as the aggregated volumes are significant enough to be marketed efficiently.

INTERNET: GOVERNOR@MISSC.STATE.WY.US • TELEPHONE (307) 777-7434 • FAX (307) 632-3909

Questions from Mr. Romero-Barcelo:

1. The State of Wyoming recently offered to sell its state royalty oil by competitive bid. We understand that the results of the bidding process were not positive. Please explain why that R-I-K effort failed.

Response:

The State of Wyoming's initial effort to market its royalty in-kind from State lands did not produce acceptable bids due to a lack of a significant volume at any single location. The State did not attempt aggregation, but we are now analyzing this option.

2. The State of Wyoming's severance and ad valorem taxes are applied to a large volume of oil and gas withing the state. We understand that if Wyoming were to take its severance and ad valorem taxes in kind on that volume, it would equal approximately the same amount of product MMS would take in kind under its federal leases. Together, this would be a significant amount of oil and gas and would create market leverage that Wyoming's producers certainly do not have today. What is your opinion of such an endeavor?

Response:

We have discussed the opportunity to significantly enhance volume by taking severance and ad valorem tax values in-kind. The ability of the State to market both state and federal R-I-K shares together with R-I-K tax shares would provide very significant market leverage. This would have to be accomplished through state statutory changes. In order to overcome current oil and gas valuation issues, such legislation would need to base taxes on a percentage of production by volume. While there are advantages in this approach, we favor implementation and successful operation of a R-I-K program for royalty oil and gas before attempting to incorporate tax shares.

3. Director Quarterman's written testimony suggests that MMS is willing to develop a pilot R-I-K project with Wyoming. Is the State of Wyoming willing to work closely with the MMS and form a joint team to identify and develop a mutually beneficial R-I-K program?

Response:

The State of Wyoming has expressed to MMS staff our willingness to participate on a joint team to identify and develop a mutually beneficial R-I-K program. We are currently awaiting release of the MMS R-I-K Study before formalizing our response to Director Quarterman.

4. Do you believe an R-I-K program would have to be completely mandatory?

Response:

An R-I-K program would have to be mandatory for the lessee to allow for the efficient aggregation and marketing of royalty production. At the same time, the MMS and/or state must be willing to commit to take the full amount of royalty production from a given lease for a known period of time and with appropriate advance notice so as not to destabilize the marketing ability of producers.

5. You stated that the States must have the option of taking their 50% share of gross receipts to market themselves. In a market such as Wyoming, with scattered leases, would that be cost effective? And, would you run the risk of diminishing the market power gained by aggregating a substantial volume of oil and gas?

Response:

Wyoming would only be interested in exercising an option to market its own 50% share of in-kind royalty if the State determined this to be cost effective. In states with significant volumes of production a 50% share of gross receipts could provide significant marketable volumes. However, as stated in my testimony to the Subcommittee, an opportunity for a state to market the federal share as well would provide additional market power especially important to lower production states.

Sincerely,

Jim Magagna

Jim Magagna, Director
Office of State Lands and Investments
and
Federal Land Policy

CONTINENTAL
RESOURCES, INC.

September 2, 1997

Barbara Cubin
Chairman, Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
Committee on Resources
Washington, DC 20515

Dear Chairman Cubin:

Enclosed are my responses to the questions by you and Representative Romero-Barcelo. Thank you for giving me the opportunity to testify before you and your committee. It was an experience I will never forget. If you have additional questions you wish to ask me, please feel free to do so. I will do my best in responding accurately and promptly. I apologize for the lack of promptness in these responses.

Sincerely,

Sue Ann Hamm

Sue Ann Hamm

302 N. Independence
P.O. Box 1032 Enid, Oklahoma 73702
(405) 233-8955

QUESTIONS FROM CHAIRMAN CUBIN

Question 1. Do you think, given the great geographic diversity of federal royalty production, that R-I-K can be accomplished for all oil producing areas?

Yes, if a company as small as ours can take its oil from one thousand leases, which have significant geographic diversity, and market downstream, then the Federal Government can do so also for its twenty-five thousand leases. Someone is already marketing this oil in some manner. There is no reason the Federal Government could not take over this function, through a marketing agent, and be very successful.

Question 2. You and your company obviously are in business by taking risks which the MMS appears unwilling to incur if the government's share is marketed. Could you briefly elaborate for the record how Continental Resources profits from its "marketing" of crude oil?

1. Reduce costs to move the oil to market:
The most important act we do, to maximize the net value of our oil downstream, is to reduce the total cost to place it at a downstream market. Holding transportation costs low is a key element to reducing total costs. As I mentioned in my oral testimony, sometimes we have had to build pipelines to lower our transportation costs. This is a risk in that we are not assured of making a return on investment. As is common knowledge, anything can happen to the production of a well. Without the anticipated production, payout of the pipeline is unlikely to occur. Aggregating as large a volume as possible with individual transporters is also a way we are sometimes able to reduce transportation costs. Often the transporters' rates are lower if they are assured of a larger volume to transport.

A risk we take which can, if not reduce costs, then at least stabilize the costs to place the oil at a downstream market, is to lock in on exchange differentials. Many call this a risk, however, I feel more comfortable knowing ahead our costs to place the oil at a downstream market. We try to keep focused on what we will make, rather than looking back, after the fact, and counting what we could have made.

2. Maximize value of the oil:
Beyond reducing the costs to move the oil to market, we look for ways to enhance the value of the oil once it is at a downstream market. We do this by aggregating our volumes where at all possible. We can attract more buyers with a larger volume. Since this increases competition, we have greater opportunities for increasing our price. We also attempt to maximize the value of the oil by researching buyers and their current needs, the different methods of selling the physical crude, and these methods current relationships to one another. To give an example, sometimes the Posting Plus market yields more than the NYMEX "market on close." We watch these numbers daily, discover which yields the highest numbers for that day, and sell accordingly.

Question 3. Can R-I-K accomplish administrative cost savings over the present valuation program? And can it enhance revenue to all concerned?

Without a doubt, administrative overhead will be lower with R-I-K. It takes a fraction of the people to market minerals that it takes to audit all the producers who are doing the marketing now. Look at the Alberta, Canada program, which employs thirty three (33) people to market its one hundred forty-six thousand (146,000) barrels of oil a day. This volume is very similar to the Federal Government's, which is two hundred four thousand (204,000) barrels of oil a day.

There are large oil companies in the United States with volumes in the hundreds of thousands of barrels. These oil companies employ comparatively small staffs to market their production. MMS employs approximately nine hundred fifty (950) people in its Revenue Management Program. I do not know of any oil company that employs any where near that many people in its oil and gas marketing departments. I would assume that these companies would staff their marketing departments with more people if it made economic sense. That is, if the increased number of people could enhance revenue more than the increased costs of overhead. Evidently it does not.

R-I-K should, at the very least, maintain a revenue neutral position for our government's royalty oil and gas. With the proper program, and the results averaged over several years time, it has great possibility for increasing our government's revenue. The reason this is so evident to me is that we have had success in marketing our own oil and gas. By taking control of the marketing of our oil and gas, by aggregation and by selling downstream, where at all possible, we have enhanced our revenue over the number it would have been if we had continued to sell at the lease.

Questions from Mr. Romero-Barcelo'

1. Ms Hamm, it seems that if the federal government were to take its onshore oil production "in kind" and place it with a marketer/producer, that marketer/producer would have more leverage than other marketer/producers to negotiate better prices on its own oil.

From my experience, aggregating our volumes has enhanced the value of our oil. I believe that even more volumes would give us the opportunity to increase the value even more. I stress the word opportunity. In answer, yes, a producer/marketer should have more leverage with additional crude oil. However, to assume that it automatically had more leverage than other marketer/producers would be erroneous, since possessing leverage would depend on the presence of various circumstances. Some situations resulting in leverage, or an advantage over others, would be ownership of transportation facilities such as pipelines and trucks, ownership of refineries, and marketing arrangements or transportation arrangements under favorable, long term contracts. None of these conditions necessarily involve a large volume of production. However, if there is an advantage, both the government and producer/marketer will benefit. This is why states like Texas have experienced an increase in revenue when volumes are taken-in-kind.

What guarantee would there be that this marketer/producer would negotiate the federal government's oil production at the same price it gets for its now-more-valuable product?

By requiring the producer/marketer to commingle its production with the government's production, just as Alberta, Canada's government does, our government could be assured of receiving the same price as the producer/marketer receives. Our government would retain the right to audit this company to assure itself of the proper commingling and allocation of proceeds. Also, it would require copies of all marketing contracts and sales entered by the producer/marketer. In this way, our government could stay current and informed on all marketing arrangements. The auditing would, no doubt, be more comprehensive than is standard now. However, our government would have far fewer companies to audit, and, these companies would have consented to auditing by the terms of their marketing contract.

Additionally, market factors will ensure our government receives a fair market price. A producer/marketer will have to compete with others before selection as the government's agent.

2. How could the government be assured that the marketer was getting the best price? What safeguards would be necessary? For instance, the MMS suggests that the price be equal to a published price, such as the NYMEX.

Our government should have high and competitive standards in choosing its agent. It should choose a producer/marketer with its own production delivered into the same market center as the government's production. Commingling the government's production with the agent's would give our government assurance of receiving the same price as the agent's price. Also, it should choose a producer/marketer with a track record of marketing its own oil.

If this price obtained were the same as NYMEX, it would be purely coincidental. NYMEX is a paper market. Our government's royalty barrels are wet barrels. Accordingly, they should be priced based upon the wet barrel market, or as it is often called, the cash market

3. What financial incentives, if any, do you believe the federal government would need to provide a marketer?

Looking at the different packages MMS would have to put together to include its entire twenty-five thousand leases, it is evident that the different packages would necessitate different marketing arrangements and compensation.

The initial costs to set up a governmental agency for R-I-K would be much greater than the costs of continued operation. Any producer/marketers involved in the first R-I-K of those particular leases will incur greater costs than succeeding companies. This is due to a number of factors. Some would include working with the government to create a system to handle R-I-K, and researching all the transportation, owners and rates available for each individual leases, There will, of course, be many more duties required of the initial producer/marketer.

In Alberta, Canada, the Crown's royalty volume is concentrated in a manner similar to our government's royalty volume in the Gulf of Mexico. The producer/marketer is paid a flat fee of $.05 per barrel. Since they do not take their gas in kind, there is no gas fee to compare.

Onshore, the royalty volume of oil and gas is much less concentrated. The aggregation alone, would be a greater chore. In all likelihood, a greater number of producers would be producing a smaller volume. This means more producers and wells per barrel/MCF to deal with. Since the volumes would be smaller, the chosen producer/marketer would receive less of an uplift in price which can result from aggregation of larger vollumes. This all translates into greater costs.

Without knowing the parameters of the marketing arrangements which will be offered for bid, it is difficult to validate a particular compensation. Market factors will help, to a great extent, in determining what the compensation should be.

4. In your testimony, you state, that MMS should have no shortage of bidders to market its oil. Yet, Wyoming recently offered oil and received only three bids which were all rejected. Why did Wyoming's offer fail? In an area such as Wyoming, what would MMS have to do to be successful?

The terms were not attractive. No effort appeared to be made to aggregate the volumes they did have. They offered small volumes which were scattered all over the state. The geographic diversity was great, and the volume was small. These two factors alone are some of the greatest obstacles to enhancing oil values by taking in kind and marketing downstream. One way to overcome geographic diversity is to find commonality in the transporters. Apparently no effort was made to determine this either.

In order to be successful in Wyoming, both the state's share and MMS's share of the royalty would need to be combined. Also, the package should contain as much of the production in Wyoming as possible in order to obtain any uplift in price possible through aggregation. Grouping production in such a way as to result in commonality of transportation and/or transportation owners, and aggregation of volumes would most likely enhance the value of the package.

5. You note that it is more difficult to take in kind oil from wells you do not also operate. MMS operates none of the wells operating on federal lands. Consequently, it would have no control over the production of any of the thousands of wells operating on federal leases. How then could the MMS be assured of a revenue-neutral or cost-effective outcome?

Lack of control is not the chief reason for the difficulty in taking in kind from outside operated wells. If I implied lack of control as the reason, I am sorry. Lack of information is the chief reason for the difficulty. We have trouble obtaining simple information such as the identity of the first purchaser. MMS has that information, and much more, as a result of their monthly forms sent in by the operators.

Lack of significant volume in outside operated wells is another reason for the difficulty in improving the price by taking the oil downstream. Our government would encounter this problem with some, but not all of its leases. In most of our outside operated wells, our net working interest is in the low single digits, unlike our Federal royalty, which is in the double digits.

Because of the lack of information, and the greater difficulty in obtaining it, administrative costs are greater for taking-in-kind the production from outside operated wells. If the volume is there, the net price, except for administrative costs, we realize is no different than for inside operated wells. Because of our government's advantages, as described above, R-I-K for our government should be more cost-effective than for us.

6. On the question of transportation, especially as it relates to those situations in which trucking crude oil would be required, it is my understanding that the Alberta government has a series of safeguards, such as monitoring valves and meters, built into its system. Would the U.S. producers be willing to allow such monitoring if the MMS switched to a royalty in kind program?

This is already being done in the U.S. It is being done onshore and offshore. It is being done by MMS, sometimes BLM, by outside working interests, by operators and by producers. It is not uncommon for more than one party to have a meter checking the volume of production and/or sales. Typically, if installed and maintained by the requesting party, the addition of check meters is not a cost to the other party, and is acceptable.

However, I do not understand how the conversion to royalty-in-kind will affect the volume which is being attributed to our government's royalty volume currently be accounted for. If a producer or transporter was measuring volume to the best of its ability with royalty-in-value, it will continue measuring accurately with royalty-in-kind.

7. If MMS were to implement R-I-K, would your company qualify or compete for one of the marketing contracts?

Our company would qualify, under almost any criteria, to market that oil of our government's which had a market center of Guernsey, Wyoming. Whether or not we would compete would depend on the compensation offered, and the parameters for marketing oil. We would need to be assured we could continue taking certain market risks. If we were to commingle our government's oil with our own, we would be bound to market both together.

We are an oil and gas exploration and production company. We make our income by selling the oil and gas which we have produced, from the wells which we have drilled. We then use this income to drill more wells. Undertaking the responsibility to market another's oil must not have a negative impact on our business. In other words, to agree to market our government's oil, we would have to be given the right to continue marketing as before. Our government would have to share in all the risks and out-of-pocket costs. In return, we would share, proportionately as to volume, all proceeds.

Questions from Chairman Cubin

1. **From Marathon's participation in the Texas program, would you be able to extrapolate the details to a national program?**

   As explained in written testimony, Marathon has only participated in the oil segment of the Texas royalty-in-kind programs. Based upon this experience, Marathon believes the Texas oil RIK programs could be extrapolated to a national program with some modifications. The first change Marathon recommends is that MMS contract with marketers to market its royalty share of the production rather than perform this function itself. MMS should contract with regional marketers to ensure that localized market dynamics are fully understood and utilized for maximum revenue enhancement. Second, MMS should take the vast majority of its production in-kind. In the Texas programs, the GLO and the University have elected not to market small volumes; this leaves both the government and the producer with an expensive administrative burden because oil valuation processes are still required for a large number of leases.

2. **What is your estimate of the transportation costs from Texas coastal leases to the onshore facility point for delivery? How would these costs compare to those on federal OCS leases, especially in the deeper waters of the Gulf of Mexico?**

   Marathon does not have any first hand experience with or first hand knowledge of the transportation costs from Texas coastal leases to any onshore facility point for delivery. The costs would vary from lease to lease depending on the production volume, proximity to existing transportation systems, type of transportation (pipeline or barge), pipeline throughput, marketing dynamics, transportation alternatives, and environmental concerns.

3. **Isn't a major bone of contention between MMS and industry the issue of "duty to market?" What is your perspective on this with respect to designing a workable R-I-K program?**

   "Duty to market" is an area of disagreement between MMS and industry which can be alleviated by a royalty-in-kind program. A duty to market and a duty to place production in marketable condition are separate and distinct obligations. MMS tries to equate the two and thus, create a fundamentally new obligation on a federal lessee of a duty to market. There is no contractual, statutory, or regulatory requirement that a federal lessee market production away from the lease at no cost to the government. The cost of marketing efforts beyond placing the production in marketable condition at or near the lease, especially the cost of marketing efforts incurred in order to obtain higher prices many hundreds of miles away from the field or area where the oil and gas were produced, is far beyond a lessee's obligation to place production in marketable condition.

   A workable royalty-in-kind program would eliminate the duty to market issue because the ultimate disposition of the production would be determined by MMS through marketers acting on its behalf. The second principle adopted by the multi-association royalty-in-kind task force contemplates that transactions at or near the lease would fulfill the lessee's royalty obligation. Once a lessee delivers the federal government's production to an RIK delivery point at or near the lease, the lessee's royalty obligation would be completely satisfied. The lessor would benefit from any increased revenue resulting from the sale of the production downstream; in return, risks and costs incurred downstream of the RIK delivery point would be borne by the lessor.

4. **In your experience with re-engineering efforts at Marathon what processes in MMS can be eliminated?**

   The key to re-engineering is to significantly improve or simplify processes. Several processes within MMS would be streamlined or significantly reduced through a royalty-in-kind program. The most obvious of these are the reporting and auditing functions. If MMS took its production in-kind, lessees would only need to report volumes. The time and cost of auditing the lessees' volumes would be significantly less than the current expenditures to audit volumes and values. Historically, volume audit issues have proven to be much easier and quicker to resolve than those arising from valuation. Furthermore, the costs incurred by MMS and DOI to pursue valuation issues through the administrative appeals process and subsequent litigation would be dramatically reduced. MMS may choose to audit the marketers under an RIK program. However, these audits would be contractual audits rather than compliance audits and should be much simpler than the current valuation audits of lessees' records. Also, the number of marketers would be a handful compared to the thousands of federal lessees. As a result of an RIK program, the royalty collection process would be streamlined and completed in a more timely manner.

   Another process which would be streamlined is royalty policy development. MMS has spent significant time over the last 15 years trying to write and rewrite oil and gas valuation regulations. An RIK program would require an initial effort to design the program, but there would not be a need to rewrite the program each time MMS perceived a change in market conditions.

Questions from Mr. Romero-Barcelo

1. **Mr. Hagemeyer, we are told that Marathon must buy approximately 83 percent of the crude oil it refines. Would Marathon be willing to pay the U.S. a premium on market center prices in order to guarantee a large supply of domestic crude oil?**

   Reported market center prices are typically spot prices, whereas the lease market is generally a term market. Marathon does not pay spot prices for term supply; rather, Marathon prefers to enter into extended term agreements, whether at the lease or a market center, to purchase crude oil in order to insure adequate refinery feedstock. Generally, market centers are trading locations for incremental barrels where short-term (month to month) shortages and overages are balanced out. Marathon buys some spot crude oil at market centers in order to meet occasional monthly shortages.

   Marathon is confused over the phrase "a premium on market center price." Market center prices are typically spot prices. As such, these prices are generally higher (or at a premium) than term prices at the lease or a market center. However, Marathon is not aware of any instance of premiums being paid on market center spot prices.

2. **With the large amount of federal oil offshore, could the federal government take its crude oil in kind and sell it to independent refiners or take it to Cushing and sell it at NYMEX or spot prices? What would be the results of the government entering the petroleum market in this way?**

MMS could dispose of its royalty oil in any manner it chose after taking custody of the crude oil at the lease. Possible dispositions would include selling the crude oil at the lease, transporting or trading the barrels to Cushing or other market centers, selling to independent or integrated refiners, and enlarging the Strategic Petroleum Reserve.

Whether MMS would take its royalty oil to Cushing or dispose of it an another manner, a successful royalty-in-kind program should provide MMS with the potential to maximize net revenues for both the federal and state governments. In order to accomplish this objective, MMS should contract with marketers to market its royalty production to obtain the best price available. These marketers should have the ability to aggregate volumes, determine the most favorable sales locations, arrange transportation, and negotiate the terms and conditions of the sale. However, in order to realize the benefits of higher revenues which can be achieved through royalty-in-kind, MMS, or its agent, must manage the risks and incur the costs associated with the marketing function.

3. **What downstream value enhancements (add-ons) should the federal government consider in taking and selling their production so that they would yield more revenues than the current "in value" system?**

Under lease terms MMS is entitled to the value of its production at the lease; it is not entitled to the value enhancements received downstream of the lease. However, royalty-in-kind provides MMS with the opportunity to achieve value enhancement if it is willing to assume the costs and risks of marketing its share of the production.

In order to maximize revenues, it is critical that MMS contract with experienced marketers in each region or area. The marketers would be responsible for determining which add-ons were available based on their experience and knowledge of the market dynamics in that particular area. Depending on the volume, location, and type of crude oil, revenue enhancement could come from aggregation, access to a larger number of purchasers, increased price flexibility, and the ability to choose which market to enter. It may be advantageous for MMS to contract with marketers having the infrastucture to aggregate and transport MMS' production.

4. **Under your R-I-K proposal, activities such as aggregation, transportation, sales location, would be shifted to the federal government. These activities are normally considered part of the dynamics of the private market place. Aside from the socio-economic effects of such a change, the federal government would have to bear the cost of these activities. What generally do these "add-ons" cost the private sector today?**

A royalty-in-kind program would not shift the costs of aggregation and transportation to the federal government or create a new burden to be borne by the lessor. MMS should bear these costs under the current regulations as these activities are downstream of the lease. However, a royalty-in-kind program would give MMS more freedom to negotiate the terms of these activities.

Based on the multi-association work group proposal, the aggregation and transportation functions would continue to be part of the private marketplace. MMS, through its marketer, would market the federal government's production in the private marketplace. The same total production would be available in the market; the only change would be the party performing the marketing function. For this reason, the impact of an RIK program on the private sector would be minimal.

There are no "general" add-on costs. The add-on costs vary depending on volume, quality, location, and many other variables which may change from month to month or even day to day.

5. **A nationwide R-I-K program would give the federal government significant market power--domestically and internationally. How would you design an R-I-K program that would avoid the types of political mischief that could result from such power? I am referring to the possibilities for stockpiling crude oil or natural gas in such a way as to affect the market place.**

Marathon does not believe a nationwide royalty-in-kind program would give the federal government power to influence the market price of crude oil either domestically or internationally. MMS' crude oil volume, while large enough to benefit from aggregation and marketing through an RIK program, is relatively small compared to total domestic production. It is estimated MMS' royalty-in-kind volume would be approximately 200,000 plus barrels per day. For the week ended August 15, 1997, API reports the total domestic production was 6,300,000 barrels per day. Based on these numbers, MMS would be marketing just over 3% of total domestic production. While the MMS' royalty oil is relatively small domestically, it is truly insignificant in the international arena.

In addition, the total domestic production of crude oil will not change, only the seller will change. Even though MMS will have a significant volume of oil, it will not have any more market presence than many large producers. The influence of the federal government, or its agent, will also be mitigated because the MMS' crude oil will not be one type of crude oil at one location. The oil will vary by location and type. Furthermore, the recent sale of crude oil from the Strategic Petroleum Reserve did not have any significant effect on crude oil markets.

MMS' volume of natural gas, especially in the Gulf of Mexico area, would be significant and give MMS, through its marketer, a market presence. However, Marathon does not believe MMS' market presence would provide it with the ability to manipulate the market.

Regarding "political mischief," as stated above, Marathon does not believe the federal government is in a position to affect or manipulate the market. The objective of MMS taking its royalty oil and gas in-kind must be to maximize federal revenues. In order to achieve this objective, the marketers, acting as MMS' agents, should be bound by the same laws and regulations as any other company to ensure there is no conflict with the objectives of the government and the oil and gas industry.

Many times there are valid reasons and acceptable strategies for increasing inventories in anticipation of market opportunities. MMS' revenues can be maximized by the use of marketers with the experience and expertise to capitalize on these market opportunities. However, any attempt to stockpile production for an extended period of time in an attempt to manipulate the price would be counter to the federal government's objective to maximize revenue. Also, the cost of deliberately stockpiling crude oil or natural gas would be prohibitive, especially the cost to store natural gas.

6. **What generally do "transportation" fees cost Marathon?**

Transportation fees may include gauging fees, gathering fees, trucking fees, loading fees, unloading fees, transfer fees, loss allowances, linefill costs, common carrier tariffs, quality bank charges, viscosity charges, indirect liquid charges, and others. Transportation fees vary from lease to lease depending on volume, location, crude type, and crude quality. There are no "general costs" for transportation.

7. If MMS were to implement R-I-K, would Marathon qualify or compete for one of the marketing contracts?

At this point in time, no qualifications for potential marketers have been established, so Marathon does not know if it would qualify as a marketer of MMS' production. However, Marathon urges MMS not to exclude any marketers that could enhance the value of MMS' production.

Assuming Marathon would qualify as a marketer of federal production, the company may want to compete for one or more of the contracts. However, Marathon would need to know the terms and conditions of any such contract before making any commitment.

Edmund P. Segner, III
Executive Vice President and Chief of Staff

Enron Corp.
P. O. Box 1188
Houston, TX 77251-1188
(713) 853-6299
Fax (713) 853-2534

September 4, 1997

The Honorable Barbara L. Cubin
Chairman
Energy and Mineral Resources Subcommittee
House Resources Committee
1626 Longworth House Office Building
Washington, DC 20515

Dear Chairman Cubin:

In response to your letter of August 7, please find below my reply to the questions posed by members of the subcommittee.

Questions by Representative Cubin

<u>Question No. 1:</u> How important is finality in terms of fulfilling the lease obligation by taking royalty-in-kind?

<u>Answer to Question No. 1:</u>

Finality is extremely important to lessees in terms of fulfilling the lease royalty obligation. Unfortunately, many lessees are currently forced to dedicate substantial resources to resolving issues concerning past royalty payments. In addition, lack of finality creates unquantifiable risks for lessees that adversely affect their decision-making process regarding commercial operations. Lessees cannot match true expenses with revenues. When additional royalties are assessed long after the production upon which they are based, a significant mismatch between revenues and costs results. Current revenues, based on current market conditions, which can vary significantly from such conditions existing at the time of the production in question, are affected. Such risks and uncertainty would be eliminated if royalties are taken in kind by the royalty recipient.

<u>Question No. 2:</u> Could you summarize other important responsibilities that the government, or its marketer, should take on a R-I-K program to be fair and equitable.

Hon. Barbara L. Cubin
September 4, 1997
Page 2

Answer to Question No. 2:

In general, under a royalty-in-kind program the government or its marketing agent should assume the midstream responsibilities that any commercial purchaser assumes today. These responsibilities include (1) contracting for or providing transportation from the leasehold to the first available market, (2) leasing storage and managing inventories, (3) aggregating volumes, and (4) assuming financial risks for price fluctuations and environmental liabilities. Such activities add value to the product beyond its value at the lease, and such value is typically recovered when the product is sold to end-users. Thus, reliance on historical market practices for assignment of responsibilities and risks, rather than a regulatory allocation, should produce the fairest and most equitable system for both parties.

Questions by Representative Romero-Barcelo

Question No. 1: Currently, MMS does not allow lessees to deduct the costs of marketing oil and gas, or the costs associated with placing oil and gas "in a marketable condition." Your testimony suggests that you disagree with this practice. And, part of your rationale for supporting a "royalty-in-kind" proposal is that the producer, or royalty payor, would be absolved of paying those costs. Instead, MMS would absorb the costs of aggregating, transportation, and the other costs associated with marketing oil and gas. I can see how the lessee, or producer, benefits under this scheme. Please explain how the public interest is well served by placing those costs on the federal government's side of the ledger.

Answer to Question No. 1:

The question states that the costs of marketing oil and gas or placing oil and gas in a "marketable" condition are not deductible from royalty payments under the current regulation and that Enron is recommending these costs be shifted to the government as a purchaser under a royalty-in-kind program. This interpretation of the regulations is incorrect.

A. Marketable Condition

Under current regulations, lessees are required to place oil and gas in a marketable condition. The regulations define "marketable condition" to mean lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area where the production occurs. This

Hon. Barbara L. Cubin
September 4, 1997
Page 3

definition is significant in two respects. First, it focuses on the actual physical condition of the lease product. Second, it only requires that the lease product be made "marketable" under contracts typical for the field or area where the production occurs, not far downstream.

The existing regulations allow lessees to deduct the costs of "processing", i.e. the costs incurred in removing hydrocarbon or non-hydrocarbon substances by processes such as absorption, adsorption and refrigeration. The costs of field processes which typically occur at or near the lease such as mechanical separation, heating, cooling, dehydration and compression (other than compression related to transportation) are not considered to be processing and are thus performed by the lessee at no cost to the lessor. Lessees are thus only required to remove impurities and otherwise enhance the physical characteristics of the lease product to the extent required to satisfy sales contracts typical for the field or area where the production occurs. Lessees have no obligation to further enhance the value of the product beyond that for which a market exists in the field or area.

B. Marketing of Oil and Gas

There are no provisions in existing regulations expressly requiring that lessees market lease production. Rather, MMS relies upon what it considers to be an implied obligation on the part of federal lessees to market production. There is some dispute whether this duty, the implied duty to market, is applicable to federal oil and gas lessees. The implied duty to market has a long history in oil and gas law in the context of leases covering privately owned lands. It has historically meant that the lessee must alone bear the costs incurred in marketing the lease product at or near the lease. The costs incurred in reaching distant markets are to be borne proportionately by the lessor and lessee. Thus, even if the duty to market is applicable to federal lessees, it only requires that the lessee seek a market in the area of production. Accordingly, costs incurred downstream of the first available market would be deductible for royalty purposes.

C. Specific Marketing Costs

The question specifically mentions the costs of transportation and aggregation as part of marketing. It indicates that these costs would be shifted from the lessee to the federal government/purchaser. This is not the case. Those costs which occur downstream as part of the marketing function are not typically borne by the lessee. First, under current regulations, the costs of transportation of lease production are expressly allowable as a deduction from royalty payments. Second, the current regulations do not and could not require aggregation. In fact, the regulations are silent on this point, but to the best of Enron's knowledge no lessee has ever been compelled to aggregate its lease production with other production to achieve a higher value resulting from economies of scale. The holder of a single lease cannot be required to own or secure control over volumes in excess of those produced pursuant to its lease. To hold otherwise would unfairly discriminate against small producers. Conversely, holders of multiple leases cannot be held to a higher duty simply because they may control other production. Requiring lessees to enter the midstream or downstream markets would be akin to requiring that farmers not only raise a crop on their land, but that they purchase the crops of others or acquire additional lands to farm to sell their own crop at a higher price.

A royalty in kind program thus does not shift costs to the federal government that it does not now bear. Rather, it vastly simplifies a system fraught with complexity and dispute. Such a simplification inures to the benefit of both the federal government and its lessees.

Question No. 2: The MMS does not believe that R-I-K programs would be as workable in the U.S. onshore leasing program with its myriad land types, revenue distributions, statutory and regulatory environments, and scattered production as it apparently is in Alberta where production is relatively concentrated and the environment is much less complex. In your testimony, you suggest that an R-I-K could and should work for both oil and gas across the board. Why do you think it would work in the onshore program?

Question No. 3: What areas of the United States are more suited for R-I-K programs?

Answers to Question Nos. 2 and 3:

We believe that a royalty-in-kind program, if properly designed and implemented, can work onshore for the simple reason that there exists a vibrant wellhead market for volumes large and small throughout the country. While simple economic realities may dictate that smaller volumes are valued differently than larger volumes, market forces will assure that all volumes receive appropriate values. Accordingly, we believe that all areas of the U.S. are suited to a royalty in kind program.

Question No. 4: The Alberta program excludes from consideration crude oil marketers who are affiliated with refiners. What is your opinion -- should the U.S. Government also preclude such marketers?

Answer to Question No. 4:

We do not believe that there is any valid reason to exclude oil producers affiliated with refiners from bidding in an open and competitive market for the government's royalty share of

Hon. Barbara L. Cubin
September 4, 1997
Page 5

production. The greater the number of potential bidders for the government's production, the greater is the likelihood that its maximum value will be achieved.

Question No. 5: If MMS were to implement R-I-K, would Enron qualify or compete for one of the marketing contracts?

Answer to Question No. 5:

While it is difficult to state unequivocally whether Enron would qualify or compete for one of the marketing contracts because the parameters of such a program have yet to be developed, Enron would be very interested in pursuing such an opportunity should it become available and if the program is designed in such a manner as to allow competitive and innovative marketers to employ their expertise in these areas.

I very much appreciate this opportunity to appear before the subcommittee. If I can be of any additional assistance, please do not hesitate to contact me.

Yours sincerely,

EP Segner III

State of Louisiana

M.J. "MIKE" FOSTER
GOVERNOR

JACK C. CALDWELL
SECRETARY

MONICA T. SURPRENANT
CHAIRMAN

DEPARTMENT OF NATURAL RESOURCES
OFFICE OF MINERAL RESOURCES
STATE MINERAL BOARD

August 27, 1997

U. S. House of Representatives
Committee on Resources
ATTN: Barbara Cubin
Chairman, Subcommittee on
Energy and Mineral Resources
Washington, DC 20515

RE: Response to Questionnaire

Dear Ms. Cubin:

Answers for Chairman Cubin

1. If we were to Take Oil in Kind, there would most likely be a negative revenue impact. We feel that we are currently getting market value for our oil, with no marketing expense being deducted. Taking-in-kind of the State's oil and gas would require the development of a totally independent accounting system which would serve to allocate taken production to lease and parish for accounting to the State Treasurer for parish road royalty income and dedicated lease income. Take-in-kind would require much additional cost of hiring the required expertise to value and market the product. Majority of production comes from leases which do not allow take-in-kind.

Answers for Congressman Romero-Barcelo

1. The State of Louisiana does not have a R-I-K program for its leases.

2. Our lack of knowledge of the administrative costs of present MMS programs precludes our attempting to focus many savings by switching over to a take-in-kind program. Any savings derived from administrative relief of valuations disputes may in fact be outweighed by administrative costs for the R-I-K program.

P.O. Box 2827 Baton Rouge, Louisiana 70821-2827 • 625 N. 4th Street 4th Floor Baton Rouge, Louisiana 70802
Phone (504) 342-4615 Fax (504) 342-4527 E-mail omr@dnr.state.la.us Web http://www.dnr.state.la.us/mineral.htm

U. S. House of Representatives
Committee on Resources
Page 2
August 27, 1997

3. The State feels the existing regulations need to be changed. We are in support of the revised proposed regulations. We do feel, however, that starting at the NYMEX introduces a level of complexity that can be avoided simply by starting at the market centers' published spot prices. We feel that with the loosening of the requirements for a party to stay on gross proceeds (that MMS has proposed in their revised regulation) that virtually all of the independents who sell under arm's length terms will be able to stay on gross proceeds.

4. Revenue negative

5. No. Only production that can easily be aggregated (either on paper or physically) and of sufficient volume to allow MMS to obtain the best possible price, should be included in a Take in Kind program.

6. Louisiana would play no role in any MMS Take in Kind program, due to the lack of experience in this area. Depending on the year reviewed, we are collecting from $10mm to $15mm per year in oil and gas royalties from the 8g zone. To the extent that it can be shown, thru pilot programs, that R-I-K would benefit the State fiscally, we would favor inclusion of our 8g leases in a program. Again, we do not have theoretical concerns about the cost effectiveness of an R-I-K program.

Yours very truly,

Jack Caldwell /ct

Jack Caldwell
Secretary, Department of
Natural Resources